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FISCAL YEAR 2004 U.S. GOVERNMENT FINANCIAL STATEMENTS

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

Statement of David M. Walker
Comptroller General of the United States

February 9, 2005

GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-05-284T, testimony before the Committee on Government Reform, House of Representatives

Why GAO Did This Study

GAO is required by law to annually audit the consolidated financial statements of the U.S. government. Proper accounting and reporting practices are essential in the public sector. The U.S. government is the largest, most complex, and most diverse entity on earth today. Its services—homeland security, national defense, Social Security, health care, mail delivery, and food inspection, to name a few—directly affect the well-being of almost every American. Sound decisions on the current results and future direction of vital federal government programs and policies are made more difficult without timely, reliable, and useful financial and performance information.

Until the problems discussed in GAO's audit report on the U.S. government's consolidated financial statements are adequately addressed, they will continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) prevent the federal government from having reliable financial information to operate in an economical, efficient, and effective manner.

www.gao.gov/cgi-bin/getrpt?GAO-05-284T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeffrey C. Steinhoff or Gary T. Engel at (202) 512-2600.

FISCAL YEAR 2004 U.S. GOVERNMENT FINANCIAL STATEMENTS

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

What GAO Found

The federal government completed its consolidated financial statements on December 15, 2004. This is just 76 days after the end of the fiscal year—a record for timeliness. However, as in the previous 7 fiscal years, certain material weaknesses in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent GAO from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. Three major impediments to an opinion on the consolidated financial statements continue to be (1) serious financial management problems at the Department of Defense, (2) the federal government's ineffective process for preparing the consolidated financial statements, and (3) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies. Further, in our opinion, the federal government did not maintain effective internal control over financial reporting and compliance due to numerous material weaknesses.

While GAO was unable to express an opinion on the consolidated financial statements of the U.S. government, several key items deserve emphasis in order to put the information contained in the financial statements and Management's Discussion and Analysis in perspective. First, the federal government reported a $412.3 billion unified budget deficit and a $568 billion on-budget deficit in fiscal year 2004, representing approximately 3.6 percent and 4.9 percent of gross domestic product (GDP), respectively. Second, the U.S. government's reported liabilities, commitments, and other obligations grew by over $13 trillion in fiscal year 2004, primarily due to enactment of the new Medicare prescription drug benefit, and now surpass $43 trillion, representing close to four times current GDP. In addition, while the size of the nation's long-term fiscal imbalance grew significantly during the fiscal year, the retirement of the "baby boom" generation is closer to becoming a reality. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress will be necessary in order to address the nation's large and growing fiscal imbalance.

An emerging issue during fiscal year 2004 that merits concern and close scrutiny was the growing number of Chief Financial Officers (CFO) Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. The material internal control weaknesses discussed in this testimony serve to increase the risk that additional errors may occur and not be identified on a timely basis by management or the auditors, resulting in further restatements.

Mr. Chairman:

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

I would like to thank you for continuing the annual tradition of oversight hearings on this important subject. The involvement of your subcommittee remains critical to ultimately assuring continued progress in the financial management area while enhancing public confidence in the federal government as a financial steward that is accountable for its finances.

The federal government completed its consolidated financial statements on December 15, 2004. This is just 76 days after the end of the fiscal year—a record for timeliness. However, as in the 7 previous fiscal years, certain material weaknesses[1] in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government were fairly stated in conformity with U.S. generally accepted accounting principles (GAAP). Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) prevent the federal government from having reliable financial information to operate in an economical, efficient, and effective manner. Sound decisions on the current results and future direction of vital federal programs and policies are made

[1]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

more difficult without timely, reliable, and useful financial and performance information.

While the federal government has not yet been able to prepare auditable financial statements, the requirement to do so at the consolidated level, as well as at the agency level, has already yielded important results. We see continuous movement toward the ultimate goals of annual accountability and, more importantly, of development of the day-to-day financial information that the federal government will need to best address today's budgetary challenges and the looming longer-term fiscal imbalance driven by, among other things, demographic trends, rising health care costs, and new homeland security and defense commitments. Across government, financial management improvement initiatives are under way, and if effectively implemented, have the potential to appreciably improve the quality of the federal government's financial management and reporting. Individual federal agencies continue to make some progress in their efforts to modernize their financial management systems and improve financial management performance as called for in the President's Management Agenda.[2]

The Office of Management and Budget (OMB) accelerated the fiscal year 2004 financial statements reporting date for agencies to November 15, 2004, as compared with January 30, 2004, for fiscal year 2003. Twenty-two of 23 Chief Financial Officers (CFO) Act agencies[3] were able to issue their fiscal year 2004 financial statements by the accelerated reporting date and the last one was issued during the first week of December. These reporting dates represent a significant improvement over fiscal year 2003 in the timeliness of CFO Act agencies' issuance of their financial statements.

[2]The President's Management Agenda is the administration's strategy for improving the management and performance of the federal government. Its purpose is to identify and address the most significant problems facing the federal government. It contains five governmentwide and nine agency-specific goals to improve federal management and deliver results to the American people.

[3]The Federal Emergency Management Agency (FEMA) was transferred to the new Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA is no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for fiscal year 2004. DHS, along with most other executive branch agencies, is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002). 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 and deleted FEMA, increasing the number of CFO Act agencies again to 24 for fiscal year 2005.

As shown in appendix I, for fiscal year 2004, 18 of 23 CFO Act agencies were able to attain unqualified audit opinions on their financial statements from inspectors general and their contract auditors responsible for those audits. With accelerated reporting, which we support in concept, it is even more imperative that federal agency management continue to work toward fully resolving the pervasive and generally long-standing material weaknesses that have been reported at the agency level for the past 9 fiscal years. Otherwise, federal agencies may risk incurring additional costs while at the same time sacrificing reliability to achieve accelerated reporting.

In identifying improved financial performance as one of its five governmentwide initiatives, the President's Management Agenda recognized that a clean (unqualified) financial audit opinion is a basic prescription for any well-managed organization. The Principals of the Joint Financial Management Improvement Program (JFMIP)[4] defined certain measures, in addition to receiving an unqualified financial statement opinion, for achieving financial management success. These additional measures include being able to routinely provide timely, accurate, and useful financial and performance information and having no material internal control weaknesses or material noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).[5] As shown in appendix II, while the severity and magnitude of the problems identified vary greatly, our analysis of audit reports of inspectors general and their contract auditors showed that for fiscal year 2004 only 4 of the 23 CFO Act agencies had neither a material weakness in internal control, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with the requirements of FFMIA.

In this testimony, I will discuss why sound financial management today and in the future is central to meeting our nation's large and growing long-term

[4]JFMIP was a joint and cooperative undertaking of the Department of the Treasury, GAO, OMB, and the Office of Personnel Management working in cooperation with each other and other federal agencies to improve financial management practices in the federal government. Leadership and program guidance were provided by the four Principals of JFMIP—the Comptroller General of the United States, the Secretary of the Treasury, and the Directors of OMB and the Office of Personnel Management. Although JFMIP ceased to exist as a stand-alone organization as of December 1, 2004, the JFMIP Principals will continue to meet at their discretion.

[5]FFMIA of 1996, Pub. L. No. 104-208, div. A, § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996)

fiscal imbalance. I will also discuss the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors—an emerging issue that merits concern and close scrutiny. I will then highlight the major issues relating to the consolidated financial statements for fiscal years 2004 and 2003, discuss systems problems that continue to hinder federal agency accountability, and describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements.

The Nation's Fiscal Imbalance

First, I would like to spend a few minutes discussing our nation's worsening financial condition and long-range fiscal outlook. Last week, I spoke on this issue at the National Press Club as part of the Outlook 2005 Conference, which was attended by government, corporate, and nonprofit executives from around the country. I have attached a copy of my remarks at that conference to my testimony today as appendix III.

While we are unable to express an opinion on the U.S. government's consolidated financial statements, several key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *Financial Report of the United States Government* into context.

First, the federal government reported a $412.3 billion unified budget deficit and a $568 billion on-budget deficit in fiscal year 2004, representing approximately 3.6 percent and 4.9 percent of gross domestic product (GDP), respectively.[6] Second, the U.S. government's reported liabilities, commitments, and other obligations grew by over $13 trillion in fiscal year 2004, primarily due to the enactment of the new Medicare prescription drug benefit, and now surpass $43 trillion, representing close to four times current GDP.[7]

In March 2004, the Trustees of the Social Security and Medicare trust funds issued their respective 2004 annual reports on the current and projected

[6]The transactions of the Postal Service and the Social Security trust funds are classified as off-budget. As such, their reported surpluses—$4 billion for the Postal Service and $151 billion for the Social Security trust funds—are excluded from the on-budget deficit but included in the unified budget deficit.

[7]This represents the sum of selected fiscal exposures net of certain revenues (e.g., payroll taxes, beneficiary premiums) that fund some of these exposures.

status of these two programs. Once again, the trustees' reports confirmed that both the Social Security and Medicare programs are unsustainable in their present form. The trustees also noted that Medicare's financial difficulties are much more severe than those confronting Social Security. Furthermore, the new prescription drug benefit has significantly increased the federal government's commitments associated with the Medicare program. Specifically, in their 2004 report, the trustees estimated the present value cost to the federal government of this new benefit over the next 75 years to be $8.1 trillion as of January 1, 2004. The trustees reiterated the message contained in their previous reports that action to address the financial difficulties facing Social Security and Medicare should be taken in a timely manner and that the sooner these financial challenges are addressed, the more varied and less disruptive the solutions can be.

The federal government's gross debt[8] as of September 2004 was about $7.4 trillion, or about $25,000 for every man, woman, and child in the country. But that number excludes such items as the gap between promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other liabilities, commitments, and contingencies that the federal government has pledged to support. If these items are factored in, the current dollar burden for every American rises to about $145,000 per person, or about $350,000 per full-time worker.

Current financial reporting does not clearly and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it provides an unrealistic and even misleading picture of the federal government's overall performance, financial condition, and future fiscal outlook. Few federal agencies adequately show the results they are getting with the taxpayer dollars they spend. In addition, too many significant federal government revenues—as well as commitments and obligations such as those associated with Social Security and Medicare—are not adequately and consistently disclosed in the federal government's consolidated financial statements and budget, and current federal financial reporting standards do not require such disclosure. The Federal Accounting Standards Advisory Board recently completed a project on accounting and reporting of earmarked funds,

[8]The federal government's gross debt consists of debt held by the public and intragovernmental debt holdings.

which include the Social Security and Medicare trust funds, and has a project underway to consider recognition, measurement, and display of social insurance obligations.

Figure 1 shows some selected fiscal exposures. The spectrum of these exposures ranges from explicit liabilities shown on the consolidated financial statements to implicit promises embedded in current policy or public expectations.[9] These liabilities, commitments, and promises have created a fiscal imbalance that will put unprecedented strains on the nation's future spending and tax policies. Although economic growth can help, the projected fiscal gap is now so large that the federal government will not be able to simply grow its way out of the problem. Tough choices by the President and the Congress are inevitable.

Figure 1: Selected Fiscal Exposures: Sources and Examples[a]

Type	Example (dollars in billions)
Explicit liabilities	Publicly held debt ($4,297) Military and civilian pension and postretirement health ($3,059) Veterans benefits payable ($925) Environmental and disposal liabilities ($249) Loan guarantees ($43)
Explicit financial commitments	Undelivered orders ($596) Long-term leases ($39)
Financial contingencies	Unadjudicated claims ($4) Pension Benefit Guaranty Corporation ($96) Other national insurance programs ($1) Government corporations e.g., Ginnie Mae
Exposures implied by current policies or the public's expectations about the role of government	Debt held by government accounts ($3,071)[b] Future Social Security benefit payments ($3,699)[c] Future Medicare Part A benefit payments ($8,236)[c] Future Medicare Part B benefit payments ($11,416)[c] Future Medicare Part D benefit payments ($8,119)[c] Life-cycle cost including deferred and future maintenance and operating costs (amount unknown) Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac

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

[a]All figures are for end of fiscal year 2004, except Social Security and Medicare estimates, which are as of January 1, 2004.

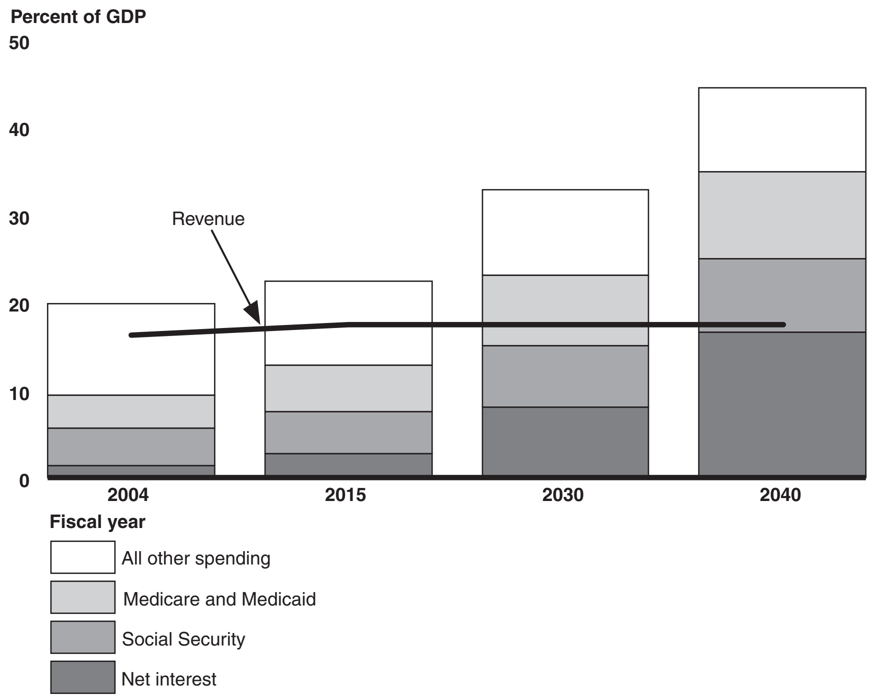
[9]While the selected fiscal exposures list provides some perspective on the range and magnitude of exposures facing the federal government, it is neither meant to be comprehensive nor to represent a universally agreed-upon list. A broader discussion of fiscal exposures can be found in GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[b]This amount includes $845 billion held by military and civilian pension and postretirement health funds that would offset the explicit liabilities reported by those funds.

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

GAO's fiscal policy simulations illustrate that the fiscal policies in place today—absent substantive entitlement reform or unprecedented changes in tax and/or spending policies—will result in large, escalating, and persistent deficits that are economically unsustainable over the long term. Assuming that discretionary spending grows with inflation and all existing tax cuts are allowed to expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenue by 2040. Moreover, if all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by 2040 total federal revenues may be adequate to pay little more than interest on the federal debt. Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national security, and adversely affect the quality of life of Americans in the future.

Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



Source: GAO's January 2005 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

The President and the Congress face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms or fiscal benchmarks that guided the federal government through the years of deficit reduction into a brief period of federal surpluses. While a number of steps will be necessary to address this challenge, as outlined in my February 2, 2005, remarks at the Press Club, truth and transparency in federal government financial reporting and budgeting are essential elements of any attempt to address the nation's long-term fiscal challenges. Further, Congress needs to have access to the long-term cost of selected spending and tax proposals before they enact related laws. The fiscal risks just mentioned can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the federal government. In addition, new budget control mechanisms will be required, along with effective approaches to successfully engage in a fundamental review, reassessment, and reprioritization of the base of federal government programs and policies. In this regard, we should not assume that all defense and homeland security expenditures are both necessary and prudent. Furthermore, the use of across-the-board adjustments to address the spending imbalance serves to avoid making the necessary difficult choices, is inequitable, and simply will not get the job done.

Potential Impact of Restatements on Agencies' Financial Statements

An emerging issue during fiscal year 2004 that merits concern and close scrutiny was the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. As shown in appendix II, at least 11[10] of the 23 CFO Act agencies fell into this category as compared with at least 5 CFO Act agencies that had restatements covering their fiscal year 2002 financial statements in fiscal year 2003. At least 3 CFO Act agencies had restatements in both years. For example, in fiscal year 2003, one agency misstated certain of its fiscal year 2002 financial statements by about $1 billion. The following year, this same agency restated certain of its fiscal year 2003 financial statements by over $5 billion. Nonetheless, for both years, the agency received unqualified audit opinions on its financial statements.

Nine of the 11 agencies having restatements for fiscal year 2003 had received unqualified opinions on their originally issued fiscal year 2003 financial statements. Seven of the nine auditors issued unqualified opinions on the restated financial statements, which in substance replace the auditors' opinions on their respective agencies' original fiscal year 2003 financial statements. For two of these nine, the auditors not only withdrew their unqualified opinion on the fiscal year 2003 financial statements but also issued other than unqualified opinions[11] on their respective agencies'

[10]The number of reported restatements in this testimony differs from our audit report dated December 6, 2004, because it includes one additional agency for which audit documentation was not made available to us in time to complete our planned audit procedures as of the date of our audit report.

[11]The auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements, and the auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

restated fiscal year 2003 financial statements because they could not determine whether there were any additional misstatements and the effect that such could have on the restated fiscal year 2003 financial statements.

The material internal control weaknesses discussed in this testimony increase the risk that additional misstatements may occur and not be identified on a timely basis by management or the auditors, resulting in further restatements. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. According to Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior period financial statements presented should only be restated for corrections of errors that caused such statements to be materially misstated. Errors in financial statements 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. The restatements to CFO Act agencies' fiscal year 2003 financial statements ranged from correcting two line items on one agency's balance sheet to numerous line items on several of another agency's financial statements. The amounts of the agencies' restatements ranged from several million dollars to over $91 billion.

As part of our fiscal year 2004 audit, we reviewed certain federal agencies' fiscal year 2003 Statement of Budgetary Resources (SBR)[12] for consistency of (1) certain information reported in the SBR with related information reported in the agencies' other financial statements and notes and (2) the offsetting receipts and net outlays reported in the SBR with published governmentwide reports. We found significant inconsistencies in these areas, which we brought to the attention of these agencies and their auditors prior to completion of their fiscal year fiscal year 2004 audits. For example, we notified a federal agency that the net outlays reported in its fiscal year 2003 SBR were overstated by about $91 billion due to certain offsetting receipts that were not reported in the SBR as offsets to outlays, as required by OMB guidance. In fiscal year 2004, this agency's fiscal year 2003 SBR was restated, reducing its previously reported net outlays from $596 billion to $505 billion. At least four of the nine agencies that received

[12]The Statement of Budgetary Resources provides information about how the resources available to the agencies were obtained (appropriations, other receipts, etc.) and used (obligations incurred and status of unobligated resources), and also reports the agencies' net outlays.

unqualified opinions on their fiscal year 2003 financial statements restated certain of these financial statements in fiscal year 2004 to address some of the significant inconsistencies we identified in the SBR.

The transparency of the restatements in the agency auditors' reports and the agencies' financial statements is also a concern of ours.[13] We believe that the auditor's report should clearly inform the reader about the correction of a material misstatement. In our view, the reader of the financial statements and auditor's report should be able to readily 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 the related auditor's opinion should be used. The reader should also be able to gain at least a basic understanding as to why the agency needed to restate its prior year financial statements and the impact of the restatement on the financial statements.

In our preliminary review of the fiscal year 2003 restatements, several issues regarding the inadequate transparency in connection with the reporting on the restatements were readily apparent. First, two of the nine agency auditors that had issued unqualified opinions the previous year on their respective agencies' originally issued fiscal year 2003 financial statements did not include a reference to management's restatement footnote in their audit reports. Second, while our analysis of restatements is just underway, the information included in the auditors' reports along with the agency's financial statements were in some instances not sufficient in our view for a reader of the financial statements to clearly understand the error that occurred and the effects it had on the financial statements. Third, while U.S. generally accepted accounting principles do not expressly require financial statements to be labeled as restated, 9 of the 11 agencies having fiscal year 2003 restatements did so, which we support. However, 2 of the 11 did not label their prior year restated financial statements as restated, which we believe also demonstrates a lack of transparency. As I highlighted earlier, in keeping with full transparency and accountability, when restatements occur, all readers should be able to understand the ramifications of what happened and that the financial statements originally issued by management, along with the related auditor's opinion, should no longer be relied on. Furthermore, agencies

[13]U.S. auditing standards require, in certain circumstances, that auditors' reports refer to or discuss restatements.

that have to restate their prior year financial statements for material errors should not refer to their prior year opinions as having been unqualified since, by definition, the restatement means they should not have received an unqualified opinion on their prior year's statement(s).

We plan to perform a more detailed review of the nature and causes of the restatements during our audit of the fiscal year 2005 consolidated financial statements, and later this year will report separately on the results of this work.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2004 and 2003

As I mentioned earlier, as has been the case for the previous 7 fiscal years, the federal government continues to have a significant number of material weaknesses related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation. Several of these material weaknesses, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's consolidated financial statements for the fiscal years ended September 30, 2004, and 2003.[14] Appendix IV describes these material deficiencies in more detail and highlights their primary effects on the consolidated financial statements and on the management of federal government operations. There may also be additional issues that could affect the consolidated financial statements that have not been identified. The material deficiencies we identified were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;

[14]We previously reported that material deficiencies prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2003.

- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;

- ensure that the federal government's consolidated financial statements were consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP;

- adequately account for and reconcile intragovernmental activity and balances between federal agencies; and

- resolve material differences that exist between the total net outlays reported in federal agencies' SBRs and the records used by Treasury to prepare the Statements of Changes in Cash Balance.

In addition to these material deficiencies, we found four other material weaknesses in internal control as of September 30, 2004. These weaknesses are discussed in more detail in appendix V, including their primary effects on the consolidated financial statements and on the management of federal government operations. These material weaknesses were the federal government's inability to

- implement effective processes and procedures for properly estimating the cost of certain lending programs, related loan guarantee liabilities, and value of direct loans;

- determine the extent to which improper payments exist;

- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis; and

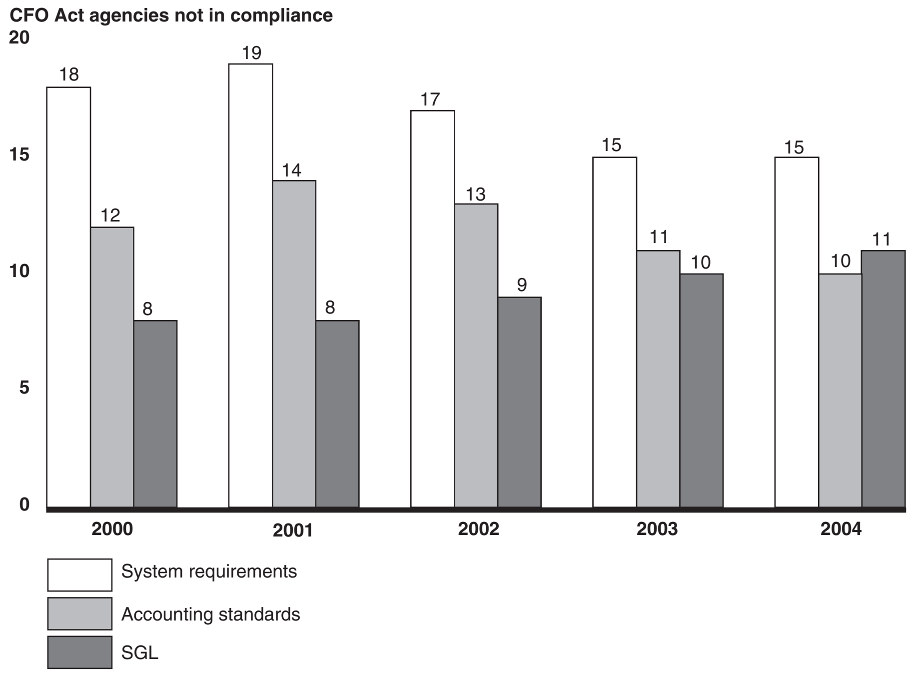
- effectively manage its tax collection activities.

Continuing Systems Problems Hinder Accountability

The ability to produce the data needed for efficient and effective management of day-to-day operations in the federal government and provide the necessary accountability to taxpayers and the Congress has been a long-standing challenge at most federal agencies. The results of the fiscal year 2004 assessments performed by agency inspectors general or their contract auditors under FFMIA show that these problems continue to affect financial management systems at most of the 23 CFO Act agencies. While the problems are much more severe at some agencies than at others, the nature and severity of the problems indicate that overall, management at most CFO Act agencies lacks the complete range of information needed for accountability, performance reporting, and decision making. These problems include nonintegrated financial systems, lack of accurate and timely recording of data, inadequate reconciliation procedures, and noncompliance with accounting standards and the U.S. Government Standard General Ledger (SGL).

The inability of agencies to meet federal financial management systems requirements continues to be the major barrier to achieving compliance with FFMIA. Under FFMIA, CFO Act agency auditors are required to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the SGL at the transaction level as part of the agencies' financial statement audits. These factors are critical for improving accountability over government operations and routinely producing sound cost and operating performance information. As shown in figure 3, instances of noncompliance with federal financial management systems requirements were the compliance issue most frequently reported by auditors. These instances of noncompliance involved not only core financial systems, but also administrative and programmatic systems.

Figure 3: Auditors' FFMIA Assessments for Fiscal Years 2000 through 2004



Source: Independent auditors' reports for fiscal years 2000 through 2004 prepared by agency inspectors general and contract auditors.

For fiscal year 2004, auditors for 16 of the 23 CFO Act agencies reported that the agencies' financial management systems did not comply substantially with one or more of FFMIA's three requirements. For 6 of the remaining 7 CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies' financial management systems did not substantially meet FFMIA requirements. The auditors for these 6 agencies did not definitively state whether the agencies' systems substantially complied with FFMIA requirements, as is required under the statute. In contrast, auditors for the Department of Labor provided positive assurance by stating that, in their opinion, the department's financial management systems substantially complied with the requirements of FFMIA. The Department of Homeland Security (DHS) was not subject to the requirements of the CFO Act in fiscal year 2004[15] and, consequently, was not required to comply with FFMIA. Accordingly, DHS's auditors did not report on DHS's compliance with FFMIA. However, the auditors identified and reported deficiencies that related to the aforementioned three requirements of FFMIA. With the recent passage of the Department of Homeland Security Financial Accountability Act,[16] DHS has been designated as a CFO agency. With this designation, DHS is now required to implement and maintain financial management systems that comply with FFMIA, and its auditors will be required to report on the department's financial management systems' compliance beginning with fiscal year 2005.

In an effort to address problems such as nonintegrated systems, inadequate reconciliations, and lack of compliance with the SGL, a number of agencies have efforts underway to implement new financial management systems or to upgrade existing systems. Agencies expect that the new systems will provide reliable, useful, and timely data to support managerial decision making and assist taxpayer and congressional oversight. Whether in government or the private sector, implementing and upgrading systems is a difficult job and brings a degree of new risk. Organizations that follow and effectively implement accepted best practices in systems development and implementation (commonly referred to as disciplined processes) can manage and reduce these risks to acceptable levels. However, our work at DOD,[17] the Department of Health and Human Services (HHS),[18] and the National Aeronautics and Space Administration[19] has shown that these agencies, which all have experienced significant problems in implementing new financial management systems, are not following the necessary

[15]For fiscal year 2004, DHS is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002).

[16]Pub. L. No. 108-330, 118 Stat. 1275, 1277 (Oct. 16, 2004).

[17]GAO, *DOD Business Systems Modernization: Billions Continue to Be Invested with Inadequate Management Oversight and Accountability*, GAO-04-615 (Washington, D.C.: May 27, 2004).

[18]GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Implementation of HHS' Financial System at Risk*, GAO-04-1008 (Washington, D.C.: Sept. 23, 2004).

[19]GAO, *National Aeronautics and Space Administration: Significant Actions Needed to Address Long-standing Financial Management Problems*, GAO-04-754T (Washington, D.C.: May 19, 2004).

disciplined processes for efficient and effective development and implementation of such systems. Further, the Department of Veterans Affairs recently halted pilot implementation of its new core financial system, in which it had invested a reported $249 million. The problems cited by the Department of Veterans Affairs Office of Inspector General were similar to those we noted at DOD, HHS, and the National Aeronautics and Space Administration. As the federal government moves forward with ambitious modernization efforts to identify opportunities to eliminate redundant systems and enhance information reliability and availability, adherence to disciplined processes will be a crucial element to reduce risks to acceptable levels. Given the nature and magnitude of the problems facing federal agencies, we recognize that it will take time, investment, and sustained emphasis to successfully modernize agencies' underlying financial management systems.

Addressing Major Impediments to an Opinion on Consolidated Financial Statements

For the past 8 fiscal years, the federal government has been required to prepare, and have its consolidated financial statements audited. Successfully meeting this requirement is closely linked to the requirements for the CFO Act agencies (and now all covered executive agencies) to also have audited financial statements. This has resulted in extensive cooperative efforts and considerable attention by agency chief financial officers, inspectors general, Treasury and OMB officials, and GAO. With the benefit of the past 8 years' experience in having the required financial statements subjected to audit, more intensified attention will be needed on the most serious obstacles to achieving an opinion on the U.S. government's consolidated financial statements. There are three primary ongoing reasons why the consolidated financial statements remained unauditable for fiscal year 2004: (1) serious financial management problems at DOD, (2) the federal government's ineffective process for preparing the consolidated financial statements, and (3) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies.

Financial Management at DOD

Essential to achieving an opinion on the consolidated financial statements is resolution of the serious financial management problems at DOD, which we have designated as high risk[20] since 1995. Overhauling DOD's financial management operations represents a challenge that goes far beyond financial accounting to the very fiber of DOD's range of business operations, management information systems, and culture. DOD's financial management problems are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or major DOD components has passed the test of an independent financial audit[21] because of pervasive weaknesses in financial management systems, operations, and controls. The seriousness of the weaknesses in DOD's business operations underscores the importance of no longer condoning the status quo at DOD. Although the Secretary of Defense and several key agency officials have shown commitment to transformation, as evidenced by key initiatives such as the Business Management Modernization Program and the Financial Improvement Initiative, little tangible evidence of significant broad-based and sustainable improvements has been seen in DOD's business operations to date. For example, the department's former comptroller started the Financial Improvement Initiative with the goal of obtaining an unqualified opinion for fiscal year 2007 on DOD's departmentwide financial statements; however, the initiative still lacks a clearly defined, well-documented, and realistic plan to make the stated goal a reality. In particular, the initiative lacks several of the key elements critical to success, including (1) a comprehensive, integrated plan; (2) results-oriented goals and performance measures; and (3) effective oversight and monitoring. For DOD to successfully transform its business operations, it will need a comprehensive and integrated business transformation plan; people with the skills, responsibility, and authority to implement the plan; an effective process and related tools, such as a business enterprise architecture;[22] and results-oriented performance measures that link institutional, unit, and individual personnel goals and expectations to promote accountability for results.

[20]GAO identifies areas at high risk due to either their greater vulnerabilities to waste, fraud, abuse, and mismanagement or major challenges associated with their economy, efficiency, or effectiveness.

[21]Although not major DOD components, the Military Retirement Fund received an unqualified opinion on its fiscal year 2004 financial statements, and the DOD Medicare-Eligible Retiree Health Care Fund received a qualified opinion on its fiscal year 2004 financial statements.

[22]A business enterprise architecture is a well-defined blueprint for operational and technological change.

Preparing the Consolidated Financial Statements

The federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. During fiscal year 2004, Treasury made progress in laying the foundation to address certain long-standing material deficiencies in preparing the consolidated financial statements. Foremost is the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements rather than using federal agencies' SGL data as Treasury had done in previous years to compile the consolidated financial statements. The goal of the new system is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support. For the fiscal year 2004 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, which is an important first step. The automated system, though, was not yet at the stage of development that it could be used to compile the consolidated financial statements from the information that was captured.

Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the CFOs of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners.[23] In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2004 and 2003. For fiscal year 2004, based on trading partner information provided in GFRS, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the material

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

differences, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Many CFOs simply indicated that they were unable to explain the differences with their trading partners. For both fiscal years 2004 and 2003, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Closing Comments

The U.S. government is the largest, most complex and most diverse entity on earth today. Its services and programs—homeland security, national defense, Social Security, health care, mail delivery, and food inspection, to name just a few—directly affect the well-being of almost every American. Our nation's large and growing long-term fiscal imbalance, which is driven largely by known demographic trends and rising health care costs—coupled with new homeland security and defense commitments and the recent downward trend in revenue as a share of GDP—continues to sharpen the need to fundamentally review and reexamine basic federal entitlements, as well as other mandatory and discretionary spending and tax policies. Clearly, tough choices will be required to address the resulting structural imbalance.

Sound decisions on the current results and future direction of vital federal programs and policies are made more difficult without timely, reliable, and useful financial and performance information. Proper accounting and financial reporting practices are essential in the public sector. Until the problems discussed in our audit report are adequately addressed, they will continue to present a number of adverse implications for the federal government and the taxpayers, which are outlined in our report. At the same time, the need for timely, reliable, and useful financial and performance information is greater than ever.

There will need to be ongoing and sustained top management attention to business systems transformation at DOD to address what are some of the most difficult financial management challenges in the federal government. As noted in our recent high-risk report, we also believe that the implementation of a new Chief Management Officer position at DOD will be needed in order for the department to succeed in its overall business transformation plan. Further, continued leadership from OMB and Treasury will be important to resolve the issues that have prevented us from expressing an opinion on the consolidated financial statements.

In closing, Mr. Chairman, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by your subcommittee's hearings. It will also be key that the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving these problems and that they support improvement efforts.

Contacts

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Fiscal Year 2004 Audit Results

Selected Major Federal Departments and Agencies: Fiscal Year 2004 Audit Results, Principal Auditors, and Number of Other Audit Contractors

23 CFO Act agencies	Audit results	Principal auditor	Number of other audit contractors
Agency for International Development	Unqualified	Inspector General	1
Agriculture	Unqualified	Inspector General	3
Commerce	Unqualified	KPMG LLP	0
Defense	Disclaimer	Inspector General	1
Education	Unqualified	Ernst & Young LLP	0
Energy	Unqualified	KPMG LLP	0
Environmental Protection Agency	Unqualified	Inspector General	0
General Services Administration	Unqualified	PricewaterhouseCoopers LLP	0
Health and Human Services	Unqualified	Ernst & Young LLP	3
Housing and Urban Development	Disclaimer	Inspector General	1
Interior	Unqualified	KPMG LLP	0
Justice	Disclaimer	KPMG LLP	2
Labor	Unqualified	R. Navarro & Associates, Inc.	2
National Aeronautics and Space Administration	Disclaimer	Ernst & Young LLP	0
National Science Foundation	Unqualified	KPMG LLP	0
Nuclear Regulatory Commission	Unqualified	R. Navarro & Associates, Inc.	0
Office of Personnel Management	Unqualified	KPMG LLP	0
Small Business Administration	Qualified[a]	Cotton & Company LLP	0
Social Security Administration	Unqualified	PricewaterhouseCoopers LLP	2
State	Unqualified	Leonard G. Birnbaum and Company, LLP	4
Transportation	Unqualified	Inspector General	2
Treasury	Unqualified	KPMG LLP	5[b]
Veterans Affairs	Unqualified	Deloitte & Touche LLP	0
Other major agency			
Homeland Security	Disclaimer	KPMG LLP	0

Source: GAO.

[a]The Small Business Administration received qualified opinions on its fiscal year 2004 consolidated balance sheet and statements of net cost, changes in net position, and financing, and an unqualified opinion on its fiscal year 2004 combined statement of budgetary resources.

[b]In addition, GAO audited the Internal Revenue Service's financial statements and the Schedules of Federal Debt Managed by the Bureau of the Public Debt.

Fiscal year 2004 and 2003 Agency Results

	Agencies auditors' rendered unqualified opinions		Agencies restated previous year financial statements		Agencies auditors' reported unqualified opinions with no material weaknesses or noncompliance	
Agencies	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**
Agency for International Development	✓	✓				
Agriculture	✓	✓	✓	✓		
Commerce	✓	✓				
Defense			✓			
Education	✓	✓				
Energy	✓	✓			✓	✓
Environmental Protection Agency	✓	✓				
General Services Administration	✓	✓	✓			
Health and Human Services	✓	✓	✓	✓		
Homeland Security						
Housing and Urban Development		✓				
Interior	✓	✓		✓		
Justice		a	✓			
Labor	✓	✓			✓	
National Aeronautics and Space Administration						
National Science Foundation	✓	✓	✓		✓	✓
Nuclear Regulatory Commission	✓	b	✓			
Office of Personnel Management	✓	✓	✓			
Small Business Administration			✓			
Social Security Administration	✓	✓			✓	✓
State	✓	✓	✓			
Transportation	✓	✓	✓	✓		
Treasury	✓	✓		✓		
Veterans Affairs	✓	✓				
Total	**18**	**18**	**11**	**5[c]**	**4**	**3**

Source: GAO.

[a]The auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements.

[b]The auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion that had been previously rendered on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

[c]20 of the agencies listed, including the 5 with restatements, had received unqualified opinions on their originally issued fiscal year 2002 financial statements.

Outlook 2005 Conference The National Press Club February 2, 2005

Saving our Nation's Future: An Intergovernmental Challenge

Keynote Address By the Honorable David M. Walker Comptroller General of the United States

Thank you for that kind introduction and for the opportunity to speak to you today.

As a federal official speaking at this state and local conference, it is important to note at the outset that in today's world governments, institutions, and individuals are increasingly interconnected and interdependent. This trend is occurring both internationally and domestically and among different economic and social sectors. From a federal, state, and local government perspective, this interconnection and interdependence involves a range of issues, including tax policy, education, the environment, health care, homeland security, social welfare, and transportation.

I could talk about any number of intergovernmental challenges, but today I plan to brighten the lights and turn up the heat on an overarching problem that too many people seem content to put on the back burner. That problem is our nation's worsening financial condition and long-range fiscal outlook.

I'm sad to say that since I last spoke on this issue here at the National Press Club back in September of 2003, our nation's long-range fiscal imbalance has deteriorated significantly. Furthermore, as you all know, most state and local governments also have their own fiscal challenges and are having to make increasingly difficult choices.

We now confront three large and interrelated national deficits. The first is a large federal budget deficit. The second is a growing balance-of-payments deficit. And the third is an alarming personal savings deficit.

Frankly, it's easy to dismiss government deficits and debt as someone else's problem. But in my view, every American has both a personal reason and a civic responsibility to become more informed and involved in the coming debate over our collective fiscal future.

The American people need to realize that the fiscal choices being made in Washington today have profound consequences for the future of our country, and our children. In a nutshell, these fiscal choices will directly affect our future national security, economic vitality, and quality of life.

In the past, Americans have shrugged off warnings about the impending deficit and debt crises. Many Americans are too focused on today and aren't thinking enough about tomorrow. As Walter Shapiro pointed out in a recent column in USA Today, low interest rates and modest inflation give many Americans a false sense of security. These false perceptions are reinforced by the government's financial statements, which currently do not provide a full and fair view of our nation's current financial condition and long-term outlook. The simple truth is that our nation's financial condition is much worse than advertised. In addition, due largely to the looming retirement of the baby boomers, surging health care costs, and relatively low federal revenues as a percentage of the economy, we now face decades of red ink.

One aspect of government financial reporting in which I'm directly involved as Comptroller General of the United States is the audit of the federal government's consolidated financial statements. Every year, the federal government is required to issue a comprehensive report on its finances and operations. My agency, the U.S. Government Accountability Office (GAO), has a statutory responsibility to audit these financial statements. As the person who has to sign GAO's audit report, and a CPA, I have an official as well a professional and personal interest in ensuring that the federal government is accountable to the taxpayers. The federal government's fiscal 2004 report was issued in record time. Unfortunately, for the eighth year in a row, GAO was unable to vouch for the accuracy and completeness of the information in the financial statements.

Recent accountability failures in the private sector underscore the importance of accurate and timely financial reporting. The scandals at Enron, Worldcom, and other corporations have led to restatements of financial statements and bankruptcies that have harmed countless shareholders, employees, pensioners, and other stakeholders, including entire communities. Here in Washington, the recently announced restatements at Fannie Mae and Freddie Mac hit uncomfortably close to home. We at GAO are committed to doing our best to ensure that such accountability failures are not repeated in the federal government.

Beyond the financial statement numbers, what does the federal government's annual report say about the results that are being achieved with the taxpayer dollars being spent? The answer is not much! It's bad enough that too few agencies adequately show the results they are getting with the taxpayer dollars they spend, but policymakers also frequently do not focus on the-long-term impact of new spending and tax proposals before taking action on related legislation. Particularly troubling are the enormous commitments that we face in connection with Social Security, Medicare, Medicaid, and veteran's health care. Down the line, we could also be facing potential federal bailouts of several entities like the Pension Benefit Guaranty Corporation.

Over the years, our federal fiscal debates have gone from millions to billions to trillions. Unless you're an economist, a statistician, an actuary, or a CPA, these numbers are mind-boggling. What's a million dollars? When it comes to the federal government, a million dollars is practically pocket change. Last year, the federal government experienced a deficit that averaged more than $1 billion each and every day. That is more than $750,000 a minute.

If you're honest about keeping score and include promised but unfunded Social Security and Medicare benefits along with explicit benefit and other commitments, the federal government's obligations, current liabilities and unfunded fiscal commitments are over $43 trillion and rising. In the last year alone, this amount has risen by more than $13 trillion, largely due to the new Medicare prescription drug benefit. Yes, that's trillions with 12 zeros rather than billions with 9 zeros. To put that number into perspective, even with the recent run up in housing prices, the estimated total net worth of every American, including Bill Gates and other billionaires, is only about $47 trillion. That means that every American would have to fork over more than 90 percent of their net worth to cover the government's current promises. Stated differently, the current burden for every American works out to more than $145,000. The numbers are even worse for full-time workers, whose share now exceeds $350,000. That amount is growing every day and it isn't even tax deductible! Keep in mind that the average family income in this country is around $42,000 a year.

As bad as these numbers are, it's the real-life consequences of unchecked deficits that are truly frightening. For example, if we continue as we have, higher interest rates are inevitable. It's only a matter of when and how high. As government borrows more and more money to finance its debt, less money will be available for companies to invest to stay competitive in today's global economy. Without meaningful changes, long-term economic growth will suffer, and along with it American jobs and purchasing power. And don't forget that high budget deficits can lead to slower growth, higher interest rates and higher inflation, which in many respects is the cruelest tax of all.

By continuing to run huge budget deficits, America is partially ceding control over its own destiny to others. Why? Because America's personal savings rate has reached historic lows. So guess who's been financing much of our spending spree in recent years? The answer is foreign investors. Since 1993 the share of publicly held debt owned by international investors has more than doubled, from 19% to over 40%. Last year, foreign investors purchased nearly $399 billion in Treasury securities—just $13 billion less than the size of the 2004 deficit! If these foreign investors lose confidence in U.S. securities as a safe haven and start to move their money elsewhere, our economy could take a serious and sudden hit. The recent decline in the value of the dollar may be a warning shot in this regard.

Mounting deficits and debt will also eventually imperil many government programs and services that Americans have come to take for granted. The reality is that government functions like national defense, homeland security, education, transportation, and our judicial system fall under the category of "discretionary spending." These programs are facing increasing budget pressures, and our ability to respond to new and emerging needs is also being constrained. If we don't get serious soon, many important programs at the state and local level will also feel the crunch. Right now, state and local governments play a key role in a range of important functions, such as educating our children, housing the poor, delivering health care, and building roads and bridges. But in the future, state and local governments may not be able to count on as much federal help. Furthermore, states may also face additional unfunded federal mandates.

In the past, particularly in the decades since World War II, America was the world's engine of economic growth. We still are, but our long-term fiscal gap is so great today that there's no way we'll be able to grow our way out of the problem. Using plausible assumptions, closing our fiscal gap would require average real growth in double-digits for the next 75 years. By any measure, that's unrealistic. In fact, even during the boom years of the 1990s, the economy grew at an average annual real rate of only 3.2 percent.

If we continue on our present path, we'll see pressure for deep spending cuts or dramatic tax increases. GAO's long-term budget simulations paint a chilling picture. If we do nothing, by 2040 we may have to cut federal spending by more than half or raise federal taxes by more than two and half times to balance the budget. Clearly, the status quo is both unsustainable and difficult choices are unavoidable. And the longer we wait, the more onerous our options will become and the less transition time we will have.

So how do we start to turn things around? At the federal level, a crucial first step is to insist on truth and transparency in government operations, including federal financial reporting. The federal government must provide a fuller and fairer picture of existing budget deficits, the so-called "trust funds," and the growing financial burdens facing every American.

On the budget side, the current 10-year cash-flow projections are an improvement over past practices. But given known demographic trends, even these projections fail to capture the long-term consequences of today's spending and tax policy choices. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. This was not the case when Congress passed the Medicare prescription drug bill with its $8.1 trillion price tag. The time has also come to reinstate budget controls, such as reasonable spending caps and responsible "pay-go" rules which would require any new spending increases or tax cuts to be paid for by equivalent tax increases and/or spending cuts.

Further reforms to the substance and timing of the current appropriations and authorization processes may also be needed. When considering these reforms, we should look to the states. In some ways, the states are way ahead of the federal government in dealing with fiscal imbalances. They have made hard choices in the past— partly driven by their state constitutions, partly by their inability to print money and partly by their sensitivity to their bond ratings!

From a more strategic and results based perspective, we also need to develop a set of key national performance and outcome-based indicators to measure America's position and progress on a range of economic, security, environmental, and social issues. Key indicators can help to inform strategic planning, enhance performance and accountability reporting, and improve key decision-making. Several countries, states, and localities have already adopted key indicator systems, but I'm sorry to say the United States still lacks such a system at the national level. This has meant that at times our policymakers have been flying blind, not unlike an airplane pilot at night without an instrument panel. Importantly, we are currently looking at how states use performance information to reprioritize their budgets in tight fiscal times. We are also working with the National Academies and the OECD to help make key indicators become a reality in the U.S. and elsewhere.

Think about it. Each year, the federal government spends more than $2 trillion on a wide range of programs and operations, provides hundreds of billions of dollars in tax preferences, and issues thousands of pages of regulations. And it does all this without having enough knowledge about whether federal policies, programs, and activities are making a real difference. Based on where we are headed, we need to engage in a base-line review of the entire federal government that encompasses three key dimensions.

First, we need to undertake a top-to-bottom review of government programs, policies, functions, and activities to ensure their relevance for the 21st century. This includes both discretionary and mandatory spending. Today, many if not most government policies and programs are based on conditions that existed when Harry Truman or Dwight Eisenhower were President. We cannot afford to spend increasingly limited taxpayer dollars on government policies and programs that were designed to deal with the problems of the past or can't show they're that making a meaningful difference today. Congress and the President need to decide which programs and policies remain priorities, which should be overhauled, and which have outlived their usefulness. Importantly, increases in targeted earmark spending combined with across-the-board cuts are not substitutes for making tough and informed choices about the base of government. These trends can result in adding fat and protecting ineffective programs while cutting muscle from high-priority and high-performing programs.

Second, we need to revisit existing tax policy and enforcement efforts. Every year, our government forgoes hundreds of billions of revenue because of existing tax preferences, significant uncollected back taxes, and tax evasion. In fact, in some years, the cost of tax preferences exceeds total discretionary spending. Our complex tax system distorts decisions to work, save, and invest—and that dampens economic growth. Complexity also creates opportunities for tax evasion through vehicles such as tax shelters. All of this raises questions about fairness with taxpayers wondering whether their friends, neighbors and business competitors are paying their fair share. Clearly, comprehensive tax reform is needed. Reform could also better position the United States to compete in today's global economy—one that is increasingly knowledge-based and subject to fast-paced technological change. It's important to recognize that the ripple effects of comprehensive tax reform will be felt at all levels of government.

Third, entitlement reform is essential. We need to put Social Security and Medicare on a sound footing and make them solvent, sustainable, and secure for both current and future generations. Actually, the problems with Social Security are not that difficult to solve. In fact, we now have a window of opportunity to exceed the expectations of all Americans—whether they'll be retiring 30 days or 30 years from now. I'd be happy to tell you more about how we can do this during the question and answer period.

On the other hand, it seems clear that the biggest single domestic challenge is health care, of which Medicare and Medicaid are a big part. Mounting health care costs are a problem for governments, employers, and individuals. Despite repeated efforts to rein in health care spending, costs continue to climb. Between 1990 and 2000, U.S. health care spending rose from $696 billion to $1.3 trillion. Spending on health care is projected to more than double again by the end of this decade. Clearly, such growth is unsustainable, and it's one of the main reasons why both the Medicare and Medicaid programs are on GAO's high-risk list. It's also one of the reasons that Medicaid costs represent the fastest growing and one of the largest budget items—second only to education—for states.

The problems affecting Medicare and Medicaid will be much more difficult to solve than Social Security. More broadly, we need to reconsider how we define, deliver, and finance health care in this country—both in the public and the private sectors. We need to weigh unlimited individual wants against specific societal needs and decide how responsibility for health care should be divided among employers, individuals, and governments.

Despite the huge amounts of money we're spending on medical care, broad access to basic coverage remains an elusive goal. The rising cost of government health care programs increases budget pressures at both the federal and state levels. Rising health care costs are also discouraging additional pension coverage, constraining wage increases, and reducing the tax base because an increasing percentage of employee compensation is coming in the form of nontaxable benefits like health insurance. Some reports suggest that rising health care premiums are also causing companies to move jobs offshore, cut overall employment levels, and hire part-time rather than full-time workers.

As you may have heard about in news stories, GAO recently released its new high-risk report, which deals primarily with the here and now. GAO's high-risk report lists current government programs and functions that need special focus and immediate attention. In addition, yesterday we issued a report on the results of a GAO forum on our long-range fiscal challenges.

In the next couple of weeks, GAO will be issuing its 21st Century Challenges Report, which will discuss where we are and where we're headed as a nation. This report will include a number of illustrative questions that policymakers should consider in examining the base of government. Frankly, it's going to take many years to get us back on a prudent and sustainable long-term fiscal track but the time to start is now.

There's clearly a real payoff for prompt action. By acting now, both America and Americans can minimize the need for drastic measures and give all of us more time to adjust to any changes. By acting now, we can help to ensure that the miracle of compounding eventually works for us rather than against us—as it is today. By acting now, we can also avoid a dangerous upward spiral of deficits and debt that will ultimately harm America and every American family. By acting now, we can enhance our credibility with investors and improve public confidence in the government's ability to deal with large, complex and controversial fiscal issues before a crisis is upon us. Finally, by acting now, we can reduce the burdens that will otherwise be imposed on our children and grandchildren and give them more freedom of choice over what role they would like for government to play in the future.

As a member of the Sons of the American Revolution, I sometimes wonder what the Founding Fathers would think if they came back today. George Washington, Thomas Jefferson, Benjamin Franklin, Alexander Hamilton, and the other founders can seem larger than life, but most of them earned a living as farmers and businessmen. They understood first hand both the value of thrift and the perils of personal and public debt. Theirs was, after all, a world with debtors' prisons. With good reason, Ben Franklin said, "He who goes a borrowing goes a sorrowing."

At the same time, our first Secretary of the Treasury, Alexander Hamilton, was a realist who recognized that adding debt in times of war or economic recession may be a temporary necessity. It seems clear, however, that our Founding Fathers did not believe that adding debt in the normal course of events was either prudent or appropriate.

No less than the father of our country, George Washington felt that the most important personal value was courage and the most important institutional value was fiscal responsibility. His views are particularly timely at this point in our nation's history.

Somehow, in the last 200 years we seem to have forgotten the sound advice from Washington, Hamilton and Franklin. If the Founding Fathers were to return today, I have no doubt they'd be justifiably proud of many things our nation has accomplished, as we are. But I suspect many of them would be shocked and saddened by our willingness to forgo fiscal discipline and pile on both personal and public debt. It's likely that our Founding Fathers would see our mounting debt as a violation of our stewardship responsibility to future generations of Americans.

This is at the heart of my message. For the debate about our fiscal future is, ultimately, not about numbers but about values. The debate we are really having is about the kind of world we're prepared to pass on to our children and grandchildren. The time has come for responsible public officials to heed George Washington's words by demonstrating more individual courage and recommitting to institutional fiscal responsibility.

It's very important to emphasize here that the nation's fiscal imbalance is not a partisan issue. There are many players we could blame for our current financial situation. After all, it's been many years in the making. The point is that while we can't change the past, we can and must do something about our future.

Overcoming our fiscal challenges will take the combined efforts of both sides of the aisle in Washington and in every state capital. Right now, what we need are leaders who will acknowledge that we have a problem and are willing do something about it. In this regard, actions speak louder than words.

In my judgment, the worst thing that could happen is to continue on our present path and do nothing. Because once a crisis is upon us, we face terrible choices. And while it's true that other nations also have long-range fiscal challenges, who wants to be the best looking horse in the glue factory?

Although my message is sobering and I want you to take our situation seriously, I don't want you to go away thinking that things are hopeless or that I am pessimistic. That's far from true and those who know me will attest to the fact that I am a results oriented optimistic by nature. After all, America has overcome much more serious challenges in the past. Furthermore, in America, anything is possible with leadership, vision, commitment, and persistence. But we need to get serious and we need to act soon. Keep in mind, the passengers on the Titanic had a smooth ride and a great time until the very moment the ship hit the iceberg.

Today, every American needs to be part of the solution. In my view, our best hope for change is for people who live on Main Street to recognize the magnitude of our challenge and appreciate the risks posed by these deficits to them, their children and their grandchildren.

If the folks who live on Main Street remain silent, significant and sustainable change is unlikely. After all, why should any elected official stick his or her neck out on a complex and controversial issue if no one cares? Younger Americans especially need to become active in this discussion because they and their children will bear the heaviest burden if today's leaders fail to act.

State and local governments need to play a strong role in our fiscal challenge debate, because in the end, every government entity and public servant, myself included, is in the same boat. After all, bad news eventually flows down hill. This means we've got to start paddling together, or we'll surely sink separately.

My hope is that when you leave here today, you will spread the word among your friends and colleagues at the state and local level. We have to start doing something about America's triple deficits. Everyone from governors and mayors to rank-and-file state and local employees have a stake in this cause, and they need to become more informed and involved in demanding change and suggesting constructive and realistic solutions.

In closing, one of my favorite Presidents is Theodore Roosevelt. As a person of strong character who was trustbuster, environmentalist, internationalist and a winner of both the Medal of Honor and the Nobel Peace Prize, he showed that if you put your mind to something, anything is possible. TR said, "Fighting for the right [cause] is the noblest sport the world affords." When it comes to our current fiscal challenges, I hope you'll join me in working together as modern-day patriots to insist on the facts, speak the truth, and help save our nation's future.

Thank you for your time and attention. I'd be happy to answer any questions that you may have.

Material Deficiencies

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

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Liabilities and Commitments and Contingencies

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

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2004 and 2003, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.

Preparation of Consolidated Financial Statements

During fiscal year 2004, Treasury made progress in laying the foundation to address certain long-standing material deficiencies in preparing the consolidated financial statements. Foremost is the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements rather than using federal agencies'

Standard General Ledger data as Treasury had done in previous years to compile the consolidated financial statements. The goal of the new system is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support. Once Treasury is able to achieve this, it would eliminate a major impediment to our being able to audit the consolidated financial statements.

For the fiscal year 2004 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, which is an important first step. The automated system, though, was not yet at the stage of development that it could be used to compile the consolidated financial statements from the information that was captured. Therefore, for fiscal year 2004, Treasury had to rely primarily on Excel spreadsheets and extensive manual procedures to prepare the consolidated financial statements. As discussed in our scope limitation section of our audit report, the federal government could not produce the fiscal year 2004 consolidated financial statements in time for us to complete all of our planned auditing procedures. In addition, for fiscal year 2004, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). Specifically, during our fiscal year 2004 audit, we found the following:[1]

- Treasury's process for compiling the consolidated financial statements did not ensure that the information in these statements was fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.

- Treasury's ability to timely prepare a complete set of consolidated financial statements was greatly impaired because in some cases the financial information provided by federal agencies to Treasury did not agree to the agencies' audited financial statements, causing Treasury to

[1]Most of the issues we identified in fiscal year 2004 existed in fiscal year 2003, and some have existed for a number of years. In September 2004, we reported in greater detail on the issues we identified, in GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Further Improvement*, GAO-04-866 (Washington, D.C.: Sept. 10, 2004). This report includes about 140 recommendations to the federal government.

have to resort to last-minute, alternative methods to gather the needed information. These problems were compounded by Treasury's reliance on internal controls that were dependent on procedures that would attempt to identify any errors after they were made by an agency (detective controls) rather than implementation of internal controls that may have prevented or minimized the errors from occurring (preventive controls).

- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving a lack of (1) segregation of duties, (2) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (3) adequate support for adjustments made to the consolidated financial statements, and (4) required management reviews.

- Information system weaknesses existed within the segments of GFRS that were used during the fiscal year 2004 reporting process. We found that inappropriate access to GFRS was granted to certain Treasury personnel and that the GFRS database was not configured to prevent the alteration of data submitted by federal agencies and was used for both production and testing during the fiscal year 2004 reporting process.

- Treasury did not have the infrastructure to address the magnitude of the fiscal year 2004 financial reporting challenges it was faced with, such as an incomplete financial reporting system, compressed time frames for compiling the financial information, and inaccurate and incomplete information provided by certain federal agencies. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to ensure accurate and reliable financial reporting by the accelerated reporting date. Nevertheless, a foundation for the future was put into place and a number of lessons were learned.

- To make the fiscal years 2004 and 2003 consolidated financial statements balance, Treasury recorded a net $3.4 billion increase and a net $24.5 billion decrease, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled "Unreconciled Transactions Affecting the Change in Net Position."[2] An additional net $1.2 billion and $11.3 billion of unreconciled transactions were recorded in the Statement of Net Cost for fiscal years 2004 and 2003, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- Treasury eliminated many intragovernmental activity and balances through accounting entries for fiscal year 2004 rather than "dropping" or "offsetting" the amounts as it has done in the past, which is a positive step. However, as discussed below, amounts reported for federal agency trading partners[3] for certain intragovernmental accounts were significantly out of balance, resulting in the need for unsupported intragovernmental elimination entries in order to force the Statement of Operations and Changes in Net Position into balance. Treasury's ability to eliminate certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions, which are noted below. In addition, significant differences in other intragovernmental accounts, primarily related to appropriations, have not been reconciled and still remain unresolved. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances to the consolidated financial statements.

- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2004 showed a net operating cost of $615.6 billion, to the budget results, which for the same period showed a unified budget deficit of $412.3 billion. In addition, a net $23.2 billion "net amount of all other differences" was needed to force this statement into balance.

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

[2] Although Treasury was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the consolidated financial statements.

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

consolidated financial statements that such excluded financial information was immaterial.

- Treasury did not have an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. For example, we found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury did not provide us with documentation of its rationale for excluding this information. As a result of this and certain of the material deficiencies noted above, we were unable to determine if the missing information was material to the consolidated financial statements. In an effort to begin addressing this issue, we found that Treasury collected certain additional financial information required by GAAP in its new process for fiscal year 2004. However, due to the compressed time frames to compile the consolidated financial statements and because GFRS is still being developed, Treasury plans to analyze this information in fiscal year 2005 and determine how or whether to disclose this information in future years' consolidated financial statements.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2004 and 2003. For fiscal year 2004, based on trading partner information provided in GFRS, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the material differences, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Many CFOs simply indicated that they were unable to explain the differences with their trading partners. For both fiscal years 2004 and 2003, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Net Outlays—A Component of the Budget Deficit

OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, states that outlays in federal agencies' Statement of Budgetary Resources (SBR) should agree with the net outlays reported in the budget of the U.S. government. In addition, Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including net outlays) in the financial statements and the amounts described as "actual" in the budget of the U.S. government.

The federal government reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance) a budget deficit for fiscal year 2004 of $412.3 billion. The budget deficit is calculated by subtracting actual budget outlays from actual budget receipts.[4] In previous years, the Statement of Changes in Cash Balance reported actual budget outlays and actual budget receipts; however, for fiscal year 2004, the federal government chose not to disclose budget outlays and budget receipts in this financial statement and only included the budget deficit. As we reported for fiscal year 2003, we found $140 billion in differences between the total net outlays reported in selected federal agencies' audited SBRs and Treasury's central accounting records, which it uses to prepare the Statement of Changes in Cash Balance. Treasury again chose for fiscal year 2004 to use its central accounting records to prepare the Statement of Changes in Cash Balance without a process for identifying and resolving the differences between its

[4]Receipts and net outlays (unified budget amounts) are also reported in governmentwide reports-specifically, in the President's Budget (annually); Treasury's Final Monthly Treasury Statement, as part of leading economic indicators on federal finances (quarterly); and Treasury's Annual Combined Statement of Receipts, Outlays, and Balances of the United States Government.

central accounting records and net outlay amounts reported in the agencies' audited SBRs. For fiscal year 2004, while Treasury no longer disclosed this information in the Statement of Changes in Cash Balance, we again found material differences between the total net outlays reported in certain federal agencies' audited SBRs and the records Treasury used to prepare the Statement of Changes in Cash Balance totaling about $69 billion. In addition, we also noted reported internal control weaknesses regarding certain agencies' SBRs.

OMB's efforts in working with the agencies resulted in some notable improvements in reducing the approximately $140 billion of differences that we reported in fiscal year 2003 between the total net outlays reported in the federal agencies' SBRs and the Statement of Changes in Cash Balance. As we reported, two agencies, Treasury and HHS, accounted for about 83 percent of these differences. We found that the major cause of the differences for the two agencies for fiscal year 2003 was the treatment of offsetting receipts.[5] Some offsetting receipts for these two agencies had not been included in the agencies' SBRs, which would have reduced the agencies' net outlays and made the amounts more consistent with Treasury's records used to prepare the Statement of Changes in Cash Balance. In fiscal year 2004, a major component of HHS restated its fiscal year 2003 net outlays in its SBR, and Treasury obtained a waiver from OMB exempting it from reporting certain offsetting receipts in its SBR totaling about $16.9 billion until further research is performed. However, about $75 billion of differences we found for fiscal year 2003 still remained unreconciled as of September 30, 2004.

Until the material differences between the total net outlays reported in the federal agencies' SBRs and the records used to prepare the Statement of Changes in Cash Balance are timely reconciled, the effect of these differences on the U.S. government's consolidated financial statements will be unknown.

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

Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2004. In addition to the material deficiencies discussed in appendix IV, we found the following four other material weaknesses in internal control.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies continue to have material weaknesses and reportable conditions related to their lending activities. In fiscal year 2004, significant deficiencies in the processes and procedures used to estimate the costs of certain lending programs and value of loans receivable increased. While the Small Business Administration (SBA) made noteworthy progress to improve its cost estimation processes, additional improvements are still needed at SBA to fully resolve the deficiencies in the area so that reasonable estimates can be produced and audited in a timely manner. Further, this year at the Department of Housing and Urban Development (HUD), a new material weakness was reported. HUD lacked adequate management reviews of underlying data and cost estimation methodologies that resulted in material errors being undetected, and significant adjustments were needed. These material weaknesses at SBA and HUD, plus deficiencies at the Department of Agriculture and the Department of Education relating to the processes and procedures for estimating credit program costs, continue to adversely affect the federal government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities. Further, these weaknesses and the complexities associated with estimating the costs of lending activities greatly increase the risk that significant errors in agency and governmentwide financial statements could occur and go undetected.

Improper Payments

Across the federal government, improper payments occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds.[1] Many improper payments occur in federal programs that are administered by entities other than the federal government, such as states and municipalities. Generally,

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

improper payments result from a lack of or an inadequate system of internal control, but some result from program design issues. Federal agencies' estimates of improper payments based on available information for fiscal year 2004 exceeded $45 billion. This estimate could increase significantly over the next several years as agencies become more effective at estimating and reporting improper payment amounts for programs and activities that are susceptible to significant improper payments.[2]

Fiscal year 2004 represents the first full year that federal agencies were required to include the reports required by the Improper Payments Information Act of 2002 (IPIA)[3] in their Performance and Accountability Reports (PAR). IPIA raised improper payments to a new level of importance by requiring federal agencies to annually review all programs and activities and identify those that may be susceptible to significant improper payments. Federal agencies are to then estimate the annual amount of improper payments for those programs and activities identified as susceptible to significant improper payments. The law further requires federal agencies to report to the Congress the improper payment estimates and information on the actions the agency is taking to reduce the improper payments. The Office of Management and Budget (OMB) implementation guidance required that estimates and, if applicable, the corrective action report, be included in federal agencies' PARs beginning with fiscal year 2004.[4]

The OMB guidance also required 44 programs of 14 CFO Act agencies to report improper payment information in their fiscal year 2003 PARs. Last year, we reported that those 14 CFO Act agencies reported the required improper payment amounts for 29 of the 44 programs,[5] suggesting that despite the enhanced emphasis on improper payments and legislative reporting requirements, those agencies appeared to be struggling with

[2]OMB defines the term "significant improper payments" as "annual erroneous payments in the program exceeding both 2.5 percent of program payments and $10 million."

[3]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

[4]OMB Memorandum M-03-13, *Improper Payments Information Act of 2002 (Public Law 107-300)* (Washington, D.C.: May 21, 2003).

[5]GAO, *Financial Management: Fiscal Year 2003 Performance and Accountability Reports Provide Limited Information on Governmentwide Improper Payments*, GAO-04-631T (Washington, D.C.: Apr. 15, 2004).

estimating improper payment amounts for about one-third of their programs.

Our preliminary reviews of 29 federal agencies' fiscal year 2004 PARs further suggest that a number of agencies were not well positioned to meet the reporting requirements of IPIA. For example, while most agencies acknowledged the IPIA reporting requirements in their PARs, 8 of the 44 programs with previous reporting requirements as noted above indicated that they would be able to estimate and report on improper payments sometime within the next 4 years but could not do so now. Another 5 programs in 2 agencies with previous reporting requirements determined that improper payment amounts were insignificant for their programs. Further, 4 additional programs in 4 agencies with prior reporting requirements did not estimate improper payment amounts for their programs and were silent as to whether they would report estimates in future reports. Therefore, 32 of the 44 programs with previous reporting requirements reported estimates or reported that their improper payment amounts were insignificant in their fiscal year 2004 PARs.

Until all agencies develop and implement a systematic measurement of the extent of improper payments, the federal government cannot determine (1) the extent to which improper payments exist, (2) mitigation strategies and the appropriate amount of investments to reduce them, and (3) the success of efforts implemented to reduce improper payments.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced by hearings on information security and enactment of the Federal Information Security Management

Act of 2002[6] and the Cyber Security Research and Development Act.[7] In addition, the administration has taken important actions to improve information security, such as integrating information security into the Executive Branch Management Scorecard.[8]

Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities,[9] an issue that has been reported in our financial statement audit reports for the past 7 years. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

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

[6]Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).

[7]Pub. L. No. 107-305, 116 Stat. 2367 (Nov. 27, 2002).

[8]The Executive Branch Management Scorecard highlights agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda.

[9]GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

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