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FISCAL YEAR 2007 U.S.
GOVERNMENT
FINANCIAL STATEMENTS

Sustained Improvement in
Financial Management Is
Crucial to Improving
Accountability and
Addressing the Long-Term
Fiscal Challenge

Statement of Gene L. Dodaro
Acting Comptroller General of the United States





Highlights of [GAO-08-847T](#), a testimony before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

The Congress and the President need to have reliable, useful and timely financial and performance information to make sound decisions on the current and future direction of vital federal government programs and policies.

Unfortunately, except for the 2007 Statement of Social Insurance, GAO was again unable to provide assurance on the reliability of the consolidated financial statements of the U.S. government (CFS) due primarily to certain material weaknesses in the federal government's internal control. GAO has reported that unless these weaknesses are adequately addressed, they will, among other things, (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities.

This testimony presents the results of GAO's audit of the CFS for fiscal year 2007 and discusses the federal government's long-term fiscal outlook.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management, including ones regarding issues addressed in this testimony.

To view the full product, including the scope and methodology, click on [GAO-08-847T](#). For more information, contact McCoy Williams or Gary T. Engel at (202) 512-2600 or Susan Irving at (202) 512-9142.

FISCAL YEAR 2007 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Financial Management Is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge

What GAO Found

For the 11th consecutive year, three major impediments prevented GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. In addition, financial management system problems continue to hinder federal agency accountability. Although the federal government still has a long way to go, significant progress has been made in improving federal financial management. For example, audit results for many federal agencies have improved and federal financial system requirements have been developed. In addition, GAO was able to render an unqualified opinion on the 2007 Statement of Social Insurance. Further, for the first time, the federal government issued a summary financial report which is intended to make the information in the *Financial Report of the U.S. Government (Financial Report)* more understandable and accessible to a broader audience.

It is important that this progress be sustained by the current administration as well as the new administration that will be taking office next year and that the Congress continues its oversight to bring about needed improvements to federal financial management. Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting, can help increase understanding of the nation's long-term fiscal outlook.

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path. Addressing this challenge will require a multipronged approach. Moreover, the longer that action is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

Finally, the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. A broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2007 and 2006. 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 the continued progress in improving federal financial management while enhancing public confidence in the government as a steward that is accountable for its finances. Such hearings play a vital role in ensuring that the federal government is held accountable to the American people.

In this testimony, I will discuss (1) the major issues relating to the consolidated financial statements for fiscal years 2007 and 2006, including progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements; (2) financial management systems problems that continue to hinder federal agency accountability; (3) the challenges posed by the federal government's long-term fiscal condition and GAO's views on a possible way forward; and (4) the need for an improved federal financial reporting model. Until these issues are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Both the consolidated financial statements and our related audit report are included in the fiscal year *2007 Financial Report of the United States Government (Financial Report)*.¹ The *Financial Report* was issued by the Department of the Treasury (Treasury) on December 17, 2007.² In addition, for the first time, Treasury and the Office of Management and Budget (OMB) in coordination with GAO issued on February 14, 2008, a summary financial report entitled, *The Federal Government's Financial Health: A Citizens Guide to the 2007 Financial Report of the United States Government*. This guide is intended to make the information in the *Financial Report* more understandable and more accessible to a broader audience. The Director of OMB, the Secretary of the Treasury, and I

¹Our audit work regarding the U.S. government's consolidated financial statements was conducted in accordance with U.S. generally accepted government auditing standards.

²Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, [GAO-05-958SP](#) (Washington, D.C.: September 2005), which was prepared to help those who seek to obtain a better understanding of the *Financial Report*.

believe that the information discussed in this guide is important to all Americans. This is a good first step, and I am confident that the guide will evolve over time. Both of these reports are available through GAO's Internet site, at <http://www.gao.gov/financial/fy2007financialreport.html> and Treasury's Internet site, at <http://www.fms.treas.gov/fr/index.html>.

Summary

Certain material weaknesses³ in financial reporting and other limitations on the scope of our work resulted in conditions that for the 11th consecutive year prevented us from providing the Congress and the American people an opinion on the federal government's financial statements, other than the Statement of Social Insurance, which are referred to as the federal government's accrual basis consolidated financial statements.⁴ However, since the enactment of key financial management reforms in the 1990's, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix III, for fiscal year 2007, 19 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements. In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. In addition, federal financial systems requirements have been developed. Also, accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. Further, fiscal year 2007 marked the second year in which the Statement of Social Insurance has been provided as a basic financial statement.⁵ The

³A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

⁴Most revenues reported in the accrual basis consolidated financial statements are recorded on a modified cash basis.

⁵We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance. Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

Statement of Social Insurance displays the present value⁶ of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). Importantly, we were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government.

The federal government, however, still has a long way to go to address several principal challenges to fully realizing strong federal financial management.⁷ For example, three major impediments continue to prevent GAO from rendering an opinion on the federal government’s accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government’s inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government’s ineffective process for preparing the consolidated financial statements. Further, in our opinion, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations as of September 30, 2007, due to numerous material weaknesses. Moreover, financial management system problems continue to hinder federal agency accountability.

In our audit report, we also emphasized that the federal government’s current fiscal path is unsustainable and that tough choices by the Congress and the President are necessary to address the nation’s long-term fiscal challenge. The fiscal and cash flow implications of the federal government’s large and growing Social Security and Medicare commitments will be felt as the large baby boom generation leaves the work force and collects benefits. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits. The budget and economic implications of the baby boom generation’s retirement will only intensify as the baby boomers age. Given these and other factors, it seems clear that the nation is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time. The issues raised by this long-term fiscal challenge are issues of significance that affect every American. Committed leadership and

⁶Present value is the discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.

⁷GAO, *Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation*, [GAO-07-542T](#) (Washington, D.C.: Mar. 1, 2007).

sustained efforts by the Congress, the President, and other key individuals throughout the federal financial management community will be needed to put our nation on a more prudent and sustainable long-term fiscal path. Given the government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government's long-term fiscal outlook.

Finally, we believe the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. The current reporting model recognizes some of these needs; however, a broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2007 and 2006

As has been the case for the previous 10 fiscal years, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the U.S. government's accrual basis consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's accrual basis consolidated financial statements for the fiscal years ended 2007 and 2006.⁸ Appendix I describes the material weaknesses that contributed to our disclaimer of opinion in more detail and highlights the primary effects of these material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations.

⁸We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2006.

The material weaknesses that contributed to our disclaimer of opinion 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;
- implement effective credit reform estimation and related financial reporting processes at certain federal credit agencies;
- 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;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government's consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) properly balanced, and (3) in conformity with Generally Accepted Accounting Principles; and,
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies' financial statements and underlying financial information and records.

Due to the material weaknesses and the additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the accrual basis consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found three other material weaknesses in internal control as of September 30, 2007. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations. These other material weaknesses were the federal government's inability to

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- determine the full extent to which improper payments occur,
 - identify and resolve information security control weaknesses and manage information security risks on an ongoing basis, and
 - effectively manage its tax collection activities.

Further, our audit report discusses certain significant deficiencies in internal control at the governmentwide level.⁹ These significant deficiencies involve the following areas:

- preparing the Statement of Social Insurance for certain programs, and
- monitoring and oversight regarding certain federal grants and entities that offer Medicare health plan options.

Individual federal agency financial statement audit reports identify additional control deficiencies which were reported by agency auditors as material weaknesses or significant deficiencies at the individual agency level. We do not deem these additional control deficiencies to be material weaknesses at the governmentwide level.

Regarding agencies' internal controls, in December 2004, OMB revised OMB Circular No. A-123, *Management's Responsibility for Internal Control*, which became effective for fiscal year 2006. In fiscal year 2006, agencies began to implement the more rigorous requirements of the revised OMB Circular No. A-123, which include management identification, assessment, testing, correction, and documentation of internal controls over financial reporting for each account or group of accounts, as well as an annual assurance statement from the agency head as to whether internal control over financial reporting is effective.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multiyear implementation plans. According to OMB's *Federal Financial Management Report for 2007*, 16 of the 24 CFO Act agencies have performed assessments required by OMB Circular No. A-123 for all key processes, while the remaining 8 CFO Act agencies are phasing in implementation of the requirements by testing a portion of the key processes and providing plans for testing the remaining processes within 3 years. Also, according to that report, to

⁹See page 182 of the *Financial Report* for more details regarding these significant deficiencies.

achieve its strategic goal of improving effectiveness of internal control over financial reporting, OMB has developed priority actions that include updating guidance, as necessary, based on lessons learned from agencies' implementation of the circular. It will be important that OMB continue to monitor and oversee federal agencies' implementation of these new requirements.

Addressing Major Impediments to an Opinion on the Accrual Basis Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's accrual basis consolidated financial statements continued to be: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Extensive efforts by DOD officials and cooperative efforts between agency chief financial officers, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's accrual basis consolidated financial statements.

Financial Management at DOD

Essential to further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements is the resolution of serious weaknesses in DOD's business operations. DOD is one of the largest and most complex organizations in the world. Since the first financial statement audit of a major DOD component was attempted almost 20 years ago, we have reported that weaknesses in DOD's business operations, including financial management, not only adversely affect the reliability of reported financial data, but also the economy, efficiency, and effectiveness of its operations.

DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement, bearing responsibility, in whole or in part, for 15 of 27 high-risk areas.¹⁰ Eight of these areas are specific to DOD and include DOD's overall approach to business transformation, as well as business systems modernization and financial management. Collectively, these high-risk areas relate to DOD's major business operations, including financial management, which directly support the warfighters, including their pay, the benefits provided to their

¹⁰GAO, *High-Risk Series: An Update*, [GAO-07-310](#) (Washington, D.C.: January 2007).

families, and the availability and condition of equipment and supplies they use both on and off the battlefield.

Successful transformation of DOD's financial management operations will require a multifaceted, cross-organizational approach that addresses the contribution and alignment of key elements, including sustained leadership, strategic plans, people, processes, and technology. Congress clearly recognized, in the National Defense Authorization Act for Fiscal Year 2008,¹¹ the need for executive-level attention in ensuring that DOD was on a sustainable path toward achieving business transformation. This legislation codifies Chief Management Officer (CMO) responsibilities at a high level in the department—assigning them to the Deputy Secretary of Defense—and establishing a full-time Deputy CMO and designating CMO responsibilities within the military services. However, in less than a year, our government will undergo a change in administrations, which raises questions about the continuity of effort and the sustainability of the progress that DOD has made to date. As such, we believe the CMO position should be codified as a separate position from the Deputy Secretary of Defense in order to provide full-time attention to business transformation over the long term, subject to an extended term appointment. Because business transformation is a long-term and complex process, we have recommended a term of at least 5 to 7 years to provide sustained leadership and accountability.

Importantly, DOD has taken steps toward developing and implementing a framework for addressing the department's long-standing financial management weaknesses and improving its capability to provide timely, reliable, and relevant financial information for analysis, decision making, and reporting, a key defense transformation priority. Specifically, this framework, which is discussed in both the department's Enterprise Transition Plan (ETP)¹² and the Financial Improvement and Audit Readiness (FIAR) Plan,¹³ includes the department's Standard Financial

¹¹Pub. L. No. 110-181, § 904 (2008).

¹²The Enterprise Transition Plan is intended to describe how DOD will transition from its current or "as is" operational environment to its intended or "to be" operational capabilities. The Business Transformation Agency is the DOD agency responsible for DOD's business transformation and the development and implementation of the ETP.

¹³DOD's FIAR Plan, initially issued in December 2005 and updated each June and September, is intended to provide DOD components with a framework for resolving problems affecting the accuracy, reliability, and timeliness of financial information and obtaining clean financial statement audit opinions.

Information Structure (SFIS) and Business Enterprise Information System (BEIS). DOD intends this framework to define and put into practice a standard DOD-wide financial management data structure as well as enterprise-level capabilities to facilitate reporting and comparison of financial data across the department.

DOD's efforts to develop and implement SFIS and BEIS should help to improve the consistency and comparability of the department's financial information and reporting; however, a great deal of work remains before the financial management capabilities of DOD and its components' transformation efforts achieve financial visibility.¹⁴ Examples of work remaining include data cleansing; improvements to current policies, processes, procedures, and controls; and implementation of fully integrated systems.

In 2007, DOD introduced refinements to its approach for achieving financial statement auditability. These refinements include the following:

- Requesting audits of entire financial statements rather than attempting to build upon audits of individual financial statement line items.
- Focusing on improvements in end-to-end business processes, or segments¹⁵ that underlie the amounts reported on the financial statements.
- Using audit readiness validations and annual verification reviews of segment improvements to help ensure sustainability of corrective actions and improvements.
- Forming a working group to begin auditability risk assessments of financial systems at key decision points in their development and deployment life cycle to help ensure that the processes and internal controls support repeatable production of auditable financial statements.

We are encouraged by DOD's efforts and emphasize the necessity for consistent management oversight toward achieving financial management capabilities and reporting of meaningful and measurable transformation

¹⁴DOD defines financial visibility as providing immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost information) in support of financial accountability and efficient and effective decision making through the department in support of the missions of the warfighter.

¹⁵DOD defines a segment as a component of an entity's business and financial environment. A segment can include (1) complete or partial business processes; (2) financial systems, business systems, or both; or (3) commands or installations. According to DOD, the environment's complexity, materiality, and timing of corrective actions are all factors that are taken into consideration when defining a segment.

Intragovernmental Activity and Balances

effort benchmarks and accomplishments. We will continue to monitor DOD's efforts to transform its business operations and address its financial management challenges as part of our continuing DOD business enterprise architecture and financial audit readiness oversight.

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. 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 adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, 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 as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions and called for the establishment of an Intragovernmental Dispute Resolution Committee.

Preparing the Consolidated Financial Statements

OMB is currently working with the Chief Financial Officers Council to create the Intragovernmental Dispute Resolution Committee.¹⁶ Treasury is also taking steps to help resolve material differences in intragovernmental activity and balances. For example, Treasury is requiring federal agencies to provide a plan of action on how the agency is addressing certain of its unresolved material differences. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules and continued strong leadership by OMB and Treasury.

Although further progress was demonstrated in fiscal year 2007, 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, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP).¹⁷ Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. During fiscal year 2007, Treasury, in coordination with OMB, continued to develop and implement corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a

¹⁶The U.S. Chief Financial Officers Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of OMB and Treasury who work collaboratively to improve financial management in the U.S. government.

¹⁷Most of the issues regarding the preparation of the consolidated financial statements that we identified in fiscal year 2007 existed in fiscal year 2006, and many have existed for a number of years. In July 2007, we reported the issues we identified to Treasury and OMB and provided new recommendations for corrective action and discussed the status of certain previously issued recommendations in GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in the Preparation of the Consolidated Financial Statements of the U.S. Government*, [GAO-07-805](#) (Washington, D.C.: July 23, 2007).

difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

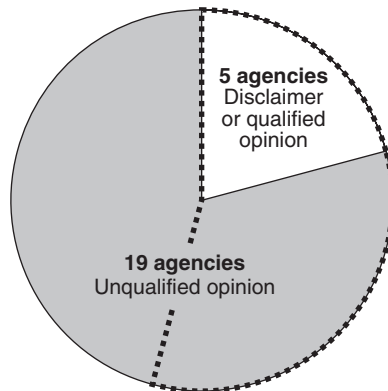
Federal Agencies' Financial Management Systems

Under the Federal Financial Management Improvement Act of 1996 (FFMIA), as a part of the CFO Act agencies' financial statement audits, auditors are required to report whether agencies' financial management systems comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. These factors, if implemented successfully, help provide a solid foundation for improving accountability over government operations and routinely producing sound cost and operating performance information.

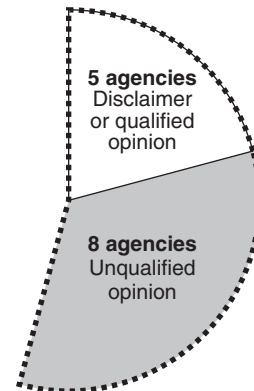
As shown in figure 1, 19 out of the 24 CFO Act agencies received an unqualified opinion on their financial statements in fiscal year 2007; however, 8 of these 19 agencies' systems did not substantially comply with one or more of the three FFMIA requirements. This shows that irrespective of these unqualified "clean" opinions on the financial statements, many agencies still do not have reliable, useful and timely financial information with which to make informed decisions and ensure accountability on an ongoing basis.

Figure 1: Comparison of 2007 Financial Statement Audit Results to FFMIA Assessments

CFO Act agencies' financial statement audit results



CFO Act agencies' systems not substantially compliant with FFMIA



Source: CFO Act agencies.

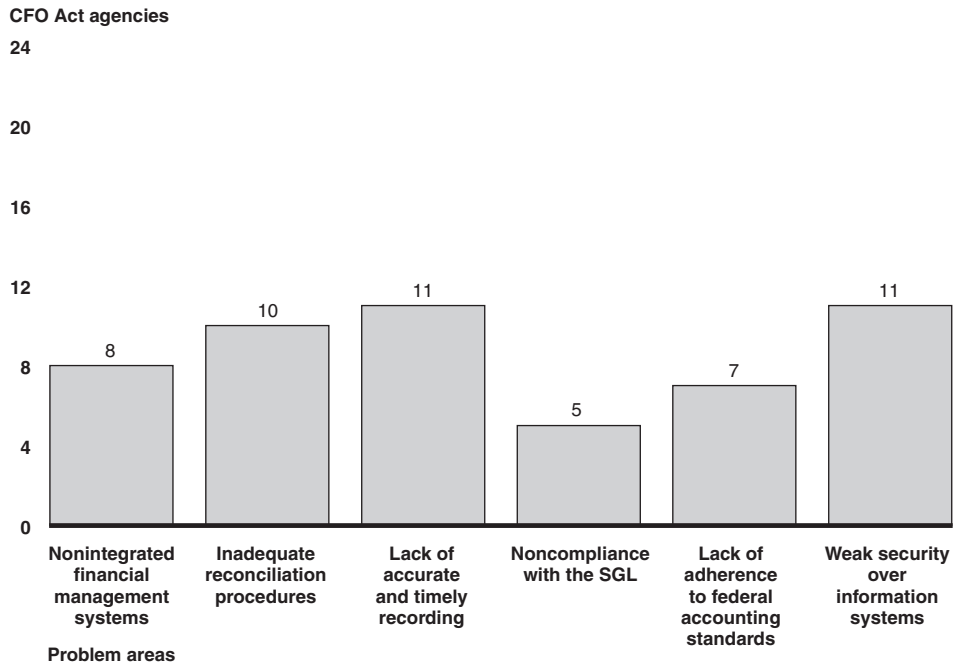
Note: Data are compiled from CFO Act agencies' Performance and Accountability Reports for fiscal year 2007.

The modernization of federal financial management systems has been a long-standing challenge at many federal agencies. As shown in figure 1, auditors reported that 13 of the 24 CFO Act agencies' systems did not substantially comply with one or more of the three FFMA requirements for fiscal year 2007. This compares with 17 agencies for fiscal year 2006. Although the number of agencies reported as not substantially compliant has declined, the federal government's capacity to manage with timely and useful data remains limited, thereby hampering its ability to effectively administer and oversee its major programs.

For fiscal year 2007, noncompliance with federal financial management systems requirements was the most frequently cited deficiency of the three FFMA requirements. One of the federal financial management systems requirements is for agencies to have integrated financial management systems. Based on our review of the fiscal year 2007 audit reports, we identified the lack of integrated financial management systems to be one of the six problem areas for the 13 agency systems that are reported as not being substantially compliant with FFMA. Figure 2 summarizes these six areas and the number of agencies with problems reported in each area.¹⁸

¹⁸The same six types of problems have been cited by auditors although the auditors may not have reported these problems as specific reasons for the agency systems not being substantially compliant with the FFMA requirements.

Figure 2: Number of CFO Act Agencies with Reported FFMIA Compliance Problems for Fiscal Year 2007



Source: GAO analysis based on independent auditors' financial statement audit reports prepared by agency inspectors general and contract auditors for fiscal year 2007.

The lack of integrated financial management systems typically results in agencies expending major time, effort, and resources, including in some cases, hiring external consultants to develop information that their systems should be able to provide on a daily or recurring basis. In addition, nonintegrated systems are more prone to error which could result in information that is not reliable, useful, or timely. Figure 2 also shows that auditors for 11 CFO Act agencies had reported the lack of accurate and timely recording of financial information as a problem in fiscal year 2007. Accurate and timely recording of financial information is essential for effective financial management. Furthermore, the majority of

participants at a recent Comptroller General’s forum¹⁹ on improving financial management systems agreed that financial management systems are not able to provide, or provide little, information that is reliable, useful, and timely to assist management in their day-to-day decision making, which is the ultimate goal of FFMIA.

Participants at the forum also discussed current financial management initiatives and the strategies for transformation of federal financial management. To reduce the cost and improve the outcome of federal financial management systems implementations, OMB continues to move forward on a key initiative—the financial management line of business (line of business), by leveraging common standards and shared solutions. OMB anticipates that the line of business initiative will help achieve the goals of improving the cost, quality, and performance of financial management operations. OMB and the Financial Systems Integration Office have demonstrated continued progress toward implementation of the line of business initiative by issuing a common governmentwide accounting classification structure, financial services assessment guide, and exposure drafts of certain standard business processes. However, as we previously recommended,²⁰ OMB needs to continue defining standard business processes. A critical factor for success will be ensuring that agencies cannot continue developing and implementing their own stovepiped systems. Failure to do so may require additional work, increase costs to adopt these standard business processes, and further delay the transformation of federal financial management systems.

In a January 2008 memo, OMB recognized the risks associated with nonstandardized processes and updated its guidance on the line of business. Current plans are for the Financial Systems Integration Office to continue developing business standards and incorporate them into software requirements and permit agencies and shared service providers

¹⁹On December 11, 2007, the Comptroller General of the United States hosted a forum in Washington, D.C., attended by Chief Financial Officers, Chief Information Officers, Inspectors General (IG) from several of the 24 CFO Act agencies, and other knowledgeable officials in the public and private sector, to discuss issues related to effective financial management system implementation across the federal government and to address long-standing federal financial management issues. See GAO, *Highlights of a Forum: Improving the Federal Government’s Financial Management Systems*, [GAO-08-447SP](#) (Washington, D.C.: Apr. 16, 2008).

²⁰GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, [GAO-06-184](#) (Washington, D.C.: Mar. 15, 2006).

to utilize only the certified products as configured. Along with these changes, continued high-priority and sustained top-level commitment by OMB and leaders throughout the federal government will be necessary to fully and effectively achieve the common goals of the line of business and FFMIA.

The Nation's Long-Term Fiscal Challenge

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. There is a need to engage in a fundamental review of what the federal government does, how it does it, and how it is financed. Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to maintain fiscal flexibility so that policymakers can respond to current and emerging social, economic, and security challenges.

While some progress has been made in recent years in addressing the federal government's short-term fiscal condition, the nation has not made progress on its long-term fiscal challenge. However, even this short-term deficit is understated: It masks the fact that the federal government has been using the Social Security surplus to offset spending in the rest of government for many years. If the Social Security surplus is excluded, the on-budget deficit²¹ in fiscal year 2007 was more than double the size of the unified deficit. For example, Treasury reported a unified deficit of \$163 billion and an on-budget deficit of \$344 billion in fiscal year 2007.

While the federal government's unified budget deficit has declined in recent years, its liabilities, contingencies and commitments, and social insurance responsibilities have increased. As of September 30, 2007, the U.S. government reported in the 2007 Financial Report that it owed (i.e., liabilities) more than it owned (i.e., assets) by more than \$9 trillion. Further, the Statement of Social Insurance in the Financial Report disclosed \$41 trillion in social insurance responsibilities, including Medicare and Social Security, up more than \$2 trillion from September 30, 2006.

²¹The on-budget deficit includes all budgetary accounts other than those designated by law as off-budget. The off-budget accounts are the Postal Service and Social Security trust funds. The unified budget is a comprehensive measure of all federal activities, including those that are on-budget and off-budget.

Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government’s long-term fiscal outlook. Over the next few decades, the nation’s fiscal challenge will be shaped largely by rising health care costs and known demographic trends. As the baby boom generation retires, federal spending on retirement and health care programs—Social Security and Medicare, and Medicaid—will grow dramatically.

The future costs of Social Security and Medicare commitments are reported in the Statement of Social Insurance in the *Financial Report*. We were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government. The statement displays the present value of projected revenues and expenditures for scheduled benefits of social insurance programs. For Social Security and Medicare alone, projected expenditures for scheduled benefits exceed earmarked revenues (i.e., dedicated payroll taxes and premiums) by approximately \$41 trillion over the next 75 years in present value terms. Stated differently, one would need approximately \$41 trillion invested today to deliver on the currently promised benefits not covered by earmarked revenues for the next 75 years.

Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

Table 1: Simplified Statement of Social Insurance as of January 1, 2007

Dollars in trillions					
	Social Security	Medicare Hospital Insurance (Part A)	Medicare Supplementary Medical Insurance (Part B)	Medicare Supplementary Medical Insurance (Part D)	Total
Present value of future revenue (earmarked contributions, taxes, and premiums)	\$34	\$11	\$5	\$2	\$52
Present value of expenditures for scheduled future benefits ^a	41	23	18	11	93
Present value of future expenditures in excess of future revenue ^b	(\$7)	(\$12)	(\$13)	(\$8)	(\$41)

Source: The Department of the Treasury.

Notes: Data are from the fiscal year 2007 Financial Report. Totals do not necessarily equal the sum of the components due to rounding.

^aThese amounts include administrative expenses for the programs.

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

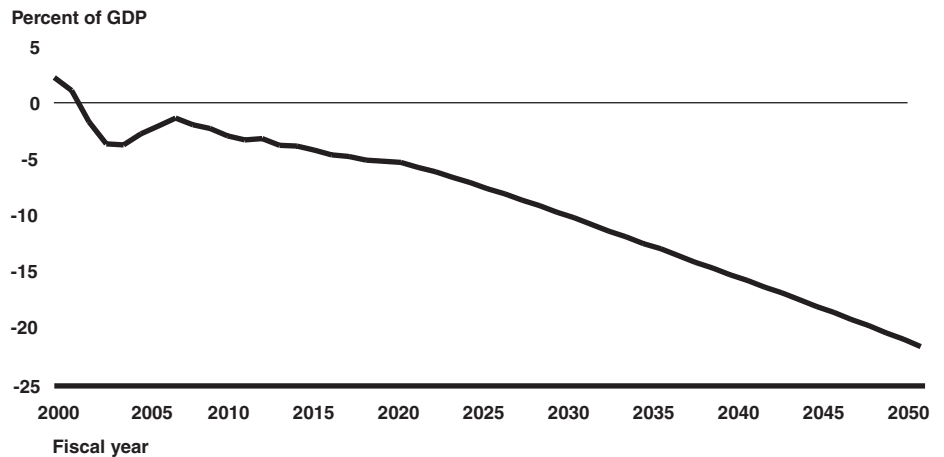
Although these social insurance commitments dominate the long-term outlook, they are not the only federal programs or activities that bind the future. GAO developed the concept of “fiscal exposures” to provide a framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending.²² In addition to the social insurance commitments, the federal government’s fiscal exposures include about \$11 trillion in liabilities reported on the Balance Sheet, \$1 trillion of other commitments and contingencies, as well as other potential exposures that cannot be quantified. So beyond dealing with Medicare and Social Security, policymakers need to look at other policies that limit the federal government’s flexibility—not necessarily to eliminate all of them but to at least be aware of them and make a conscious decision to reform them in a manner that will be responsible, equitable, and sustainable.

Long-term fiscal simulations of future revenues and costs for all federal programs offer a comprehensive assessment of the federal government’s long-term fiscal outlook. Since 1992, GAO has published long-term fiscal simulations of what might happen to federal deficits and debt levels under varying policy assumptions. GAO’s simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used. For example, figure 3 shows GAO’s simulation of the deficit path based on recent trends and policy preferences. In this simulation, we start with the Congressional Budget Office’s (CBO) baseline and then assume that (1) all expiring tax provisions are extended through 2018—and then revenues are brought to their historical level as a share of gross domestic product (GDP) plus expected revenue from deferred taxes—(2) discretionary spending grows with the economy, and (3) no structural changes are made to Social Security, Medicare, or Medicaid.²³

²²GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

²³Social Security and Medicare spending are based on the 2008 Trustees’ intermediate projections. Medicare spending is adjusted using the Centers for Medicare and Medicaid Services’ estimates assuming that physician payments are not reduced as required under current law. Medicaid spending is based on CBO’s December 2007 long-term projections adjusted to reflect excess cost growth consistent with the Trustees’ intermediate projections. Additional information about GAO’s simulation model, assumptions, data, and results can be found at <http://www.gao.gov/special.pubs/longterm/>.

Figure 3: Unified Surpluses and Deficits under GAO's Alternative Simulation



Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

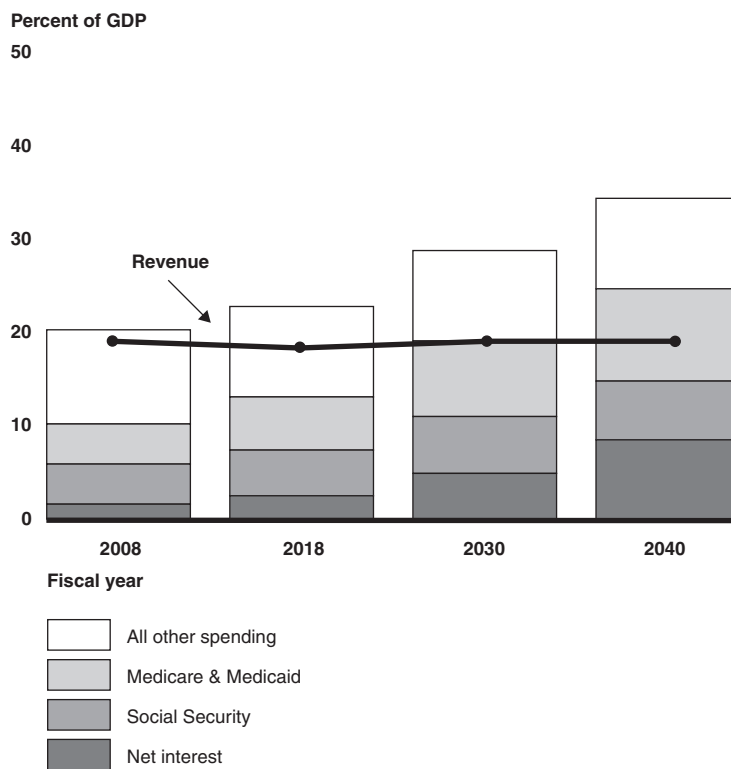
Over the long term, the nation's fiscal challenge stems primarily from rising health care costs and, to a lesser extent, the aging of the population. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today's and tomorrow's commitments.

Figure 4 looks behind the deficit path to the composition of federal spending. It shows that the estimated growth in the major entitlement programs leads to an unsustainable fiscal future. In this figure, the category "all other spending" includes much of what many think of as "government"—discretionary spending on such activities as national defense, homeland security, veterans health benefits, national parks, highways and mass transit, and foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports.²⁴ The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending. A

²⁴Discretionary spending refers to spending based on authority provided in annual appropriations acts. Mandatory spending refers to spending that the Congress has authorized in legislation other than appropriations acts that entitles beneficiaries to receive payment or that otherwise obligates the federal government to make payment.

government that in one generation does nothing more than pay interest on its debt and mail checks to retirees and some of their health providers is unacceptable.

Figure 4: Potential Fiscal Outcomes under GAO’s Alternative Simulation: Revenues and Composition of Spending as Shares of GDP



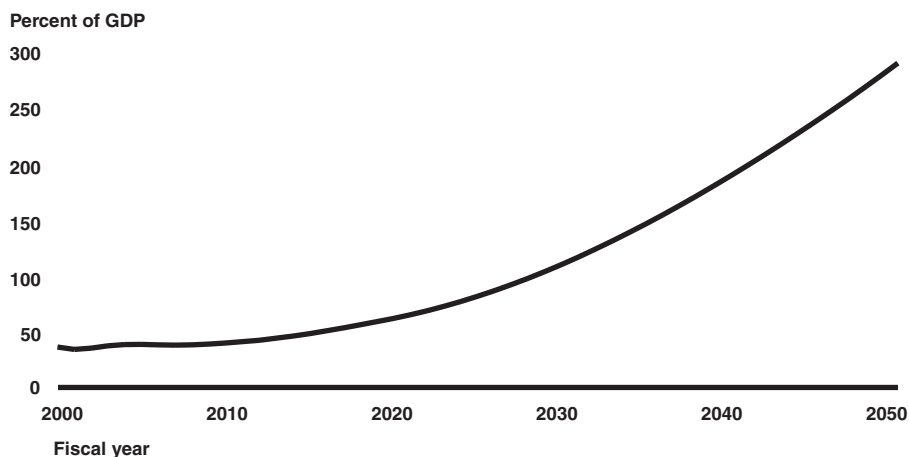
Source: GAO’s April 2008 analysis.

Note: Discretionary spending grows with GDP after 2008. Alternative minimum tax exemption amount is retained at the 2007 level through 2018 and expiring tax provisions are extended. After 2018, revenue as a share of GDP returns to its historical level of 18.3 percent of GDP plus expected revenues from deferred taxes, (i.e., taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees’ 2008 projections adjusted for the Centers for Medicare and Medicaid Services’ alternative assumption that physician payments are not reduced as specified under current law.

The federal government’s increased spending and rising deficits will drive a rising debt burden. At the end of fiscal year 2007, debt held by the public exceeded \$5 trillion. Figure 5 shows that this growth in the federal government’s debt cannot continue unabated without causing serious harm to the economy. In the last 200 years, only during and after World War II has debt held by the public exceeded 50 percent of GDP. But this is only part of the story. The federal government for years has been

borrowing the surpluses in the Social Security trust funds and other similar funds and using them to finance federal government costs. When such borrowings occur, Treasury issues federal securities to these government funds that are backed by the full faith and credit of the U.S. government. Although borrowing by one part of the federal government from another may not have the same economic and financial implications as borrowing from the public, it represents a claim on future resources and hence a burden on future taxpayers and the future economy. If federal securities held by those funds are included, the federal government's total debt is much higher—about \$9 trillion as of the end of fiscal year 2007.

Figure 5: Debt Held by the Public under GAO's Alternative Simulation

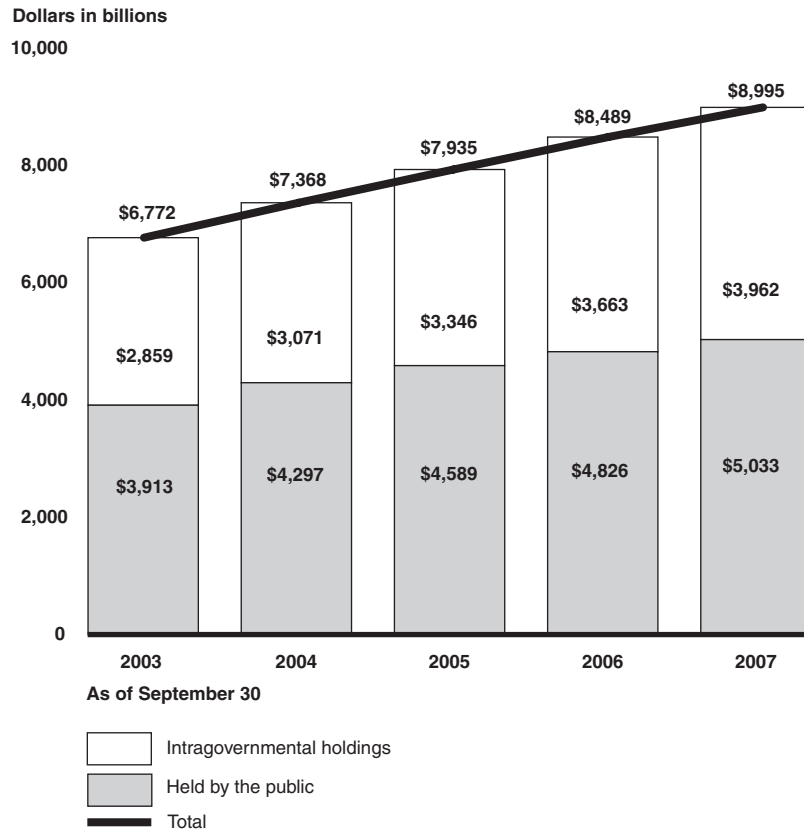


Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

As shown in figure 6, total federal debt increased over each of the last four fiscal years.

Figure 6: Total Federal Debt Outstanding



Source: The Department of the Treasury.

On September 29, 2007, the statutory debt limit had to be raised for the third time in 4 years in order to avoid being breached; between the end of fiscal year 2003 and the end of fiscal year 2007, the debt limit had to be increased by about one-third. It is anticipated that actions will need to be taken in fiscal year 2009 to avoid breaching the current statutory debt limit of \$9,815 billion.

A quantitative measure of the long-term fiscal challenge measure is called “the fiscal gap.” The fiscal gap is the amount of spending reduction or tax increases that would be needed today to keep debt as a share of GDP at or below today’s ratio. The fiscal gap is an estimate of the action needed to achieve fiscal balance over a certain time period such as 75 years. Another way to say this is that the fiscal gap is the amount of change needed to

prevent the kind of debt explosion implicit in figure 5. The fiscal gap can be expressed as a share of the economy or in present value dollars.

Under GAO's alternative simulation, closing the fiscal gap would require spending cuts or tax increases equal to 6.7 percent of the entire economy over the next 75 years, or about \$54 trillion in present value terms. To put this in perspective, closing the gap would require an increase in today's federal tax revenues of about 36 percent or an equivalent reduction in today's federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) to be maintained over the entire period.

Policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. The size of these annual tax increases and spending cuts would be more than five times the fiscal year 2007 deficit of 1.2 percent of GDP. Delaying action would make future adjustments even larger. Under our alternative simulation, waiting even 10 years would require a revenue increase of about 45 percent or noninterest spending cuts of about 40 percent. This gap is too large for the federal government to grow its way out of the problem. To be sure, additional economic growth would certainly help the federal government's financial condition and ability to address this fiscal gap, but it will not eliminate the need for action.

Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to the nation's future. As we reported in December 2007,²⁵ several countries have begun preparing fiscal sustainability reports to help assess the implications of their public pension and health care programs and other challenges in the context of overall sustainability of government finances. European Union members also annually report on longer-term fiscal sustainability. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions. These countries used a variety of measures, including projections of future revenue and spending and summary measures of fiscal imbalance and

²⁵GAO, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge*, [GAO-08-206](#) (Washington, D.C.: Dec. 20, 2007).

fiscal gaps, to assess fiscal sustainability. Last year, we recommended that the United States should prepare and publish a long-range fiscal sustainability report.²⁶ I am pleased to note that the Federal Accounting Standards Advisory Board (FASAB) will soon issue a draft of a proposed standard on fiscal sustainability reporting.

Here in the first half of 2008, the long-term fiscal challenge is not in the distant future. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits and will be eligible for Medicare benefits in less than 3 years. The budget and economic implications of the baby boom generation's retirement have already become a factor in CBO's 10-year budget projections and that impact will only intensify as the baby boomers age.

The financial markets also are noticing. Earlier this year, Moody's Investors Service issued its annual report on the United States. In that report, it noted that absent Medicare and Social Security reforms, the long-term fiscal health of the United States and the federal government's current Aaa sovereign credit rating were at risk. Likewise, Standard and Poor's noted in a recent report that Medicare and Social Security reform is necessary to prevent a much worse long-term fiscal deterioration. These comments serve to note the significant longer-term interest rate risk that the federal government faces absent meaningful action to address these long-range challenges. Higher longer-term interest costs would only serve to complicate the nation's fiscal, economic, and other challenges in future years.

At some point, action will need to be taken to change the nation's fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing and future generations will have to bear a greater burden of the cost. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time.

²⁶ GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed*, [GAO-07-1144T](#) (Washington, D.C.: July 25, 2007), and *Long-Term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today*, [GAO-07-389T](#) (Washington, D.C.: Jan. 23, 2007).

A Possible Way Forward

Meeting this long-term fiscal challenge overarches everything. It is the nation's largest sustainability challenge, but it is not the only one. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed.

In addressing the growing costs of the major entitlement programs and reexamining other major programs, policies, and activities, attention should be paid to both the spending and the revenue sides of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures²⁷—must be reexamined along with those that run through the spending side. Moving forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results.

Meeting the nation's long-term fiscal challenge will require a multipronged approach bringing people together to tackle health care, Social Security, and the tax system as well as

- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and
- reengineering and reprioritizing the federal government's existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

There are also some process changes that might help the discussion by increasing the transparency and relevancy of key financial, performance, and budget reporting and estimates that highlight the fiscal challenge. Stronger budget controls for both spending and tax policies to deal with both near-term and longer-term deficits may also be helpful.

In summary, to effectively address the nation's long-term fiscal challenge, tackling health care cost growth and other existing entitlement programs will be essential. However, this entitlement reform alone will not get the job done. The federal government also needs to reprioritize and constrain other spending and consider whether revenues at the historical average of 18.3 percent of GDP will be sufficient—that may involve discussion of the

²⁷In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.

tax system. I am pleased that GAO has been able to offer you specific analysis and tools to assist you in this important work. However, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and the fiscal clock is ticking.

The Federal Financial Reporting Model

The Financial Report provides useful information on the government's financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation's fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal challenge of the government—that is, the sustainability of the federal government's programs, commitments, and responsibilities in relation to the resources expected to be available.

The current federal financial reporting model does not clearly, comprehensively 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 does not provide the best possible picture of the federal government's overall performance, financial condition, and future fiscal outlook.

Accounting and financial reporting standards have continued to evolve to provide adequate transparency and accountability over the federal government's operations, financial condition and fiscal outlook. However, after 11 years of reporting at the governmentwide level, it is appropriate to consider the need for further revisions to the current federal financial reporting model, which could affect both consolidated and agency reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions:

- What kind of information is most relevant and useful for a sovereign nation?
- Do traditional financial statements convey information in a transparent manner?
- What is the role of the balance sheet in the federal government reporting model?

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

In addition, further enhancements to accounting and financial reporting standards are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. For example, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include (1) a Statement of Fiscal Sustainability²⁸ that provides a long-term look at the sustainability of social insurance programs in the context of all federal programs, and (2) other sustainability information, including intergenerational equity.²⁹ The Federal Accounting Standards Advisory Board is currently considering possible changes to social insurance reporting and has initiated a project on fiscal sustainability reporting.

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

Closing Comments

In closing, it is important that the progress that has been made in improving federal financial management activities and practices be sustained by the current administration as well as the new administration that will be taking office next year. Across government, financial management improvement initiatives are underway, and if effectively implemented, they have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. However, the federal government still

²⁸The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

²⁹Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

has a long way to go before realizing strong federal financial management. For DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses, but consistent and diligent management oversight toward achieving financial management capabilities, including audit readiness is needed. Federal agencies need to improve the government's financial management systems. The civilian CFO Act agencies must continue to strive toward routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis.

Addressing the nation's long-term fiscal challenge constitutes a major transformational challenge that may take a generation or more to resolve. GAO is committed to sustained attention to this fiscal challenge to help ensure that this is not the first generation to leave its children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring. Given the size of the projected deficit, the leadership and efforts of many people will be needed to put the nation on a more prudent and sustainable longer-term fiscal path.

Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current and future direction of vital federal government programs and policies are more difficult without such information. We will continue to stress the need for development of more meaningful financial and performance reporting on the federal government. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this subcommittee's leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact McCoy Williams, Managing Director; and Gary Engel, Director; Financial Management and Assurance at (202) 512-2600, as well as Susan Irving, Director; Federal Budget Analysis, Strategic Issues at (202) 512-9142. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual Basis Consolidated Financial Statements

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual basis consolidated financial statements. The federal government did not maintain adequate systems or have sufficient reliable evidence to support information reported in the accrual basis consolidated financial statements, as described below.

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.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies that account for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by certain federal credit agencies, certain deficiencies in the Department of Agriculture's credit reform processes contributed to its auditor being unable to obtain sufficient, appropriate evidence to support related accounts. As such, for fiscal year 2007, we have added this area to the list of material weaknesses contributing to our disclaimer of opinion on the accrual basis consolidated financial statements.

These issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Moreover, these weaknesses continue to

adversely affect the federal government's ability to support annual budget requests for federal lending programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.

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 the past, 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. This year, the auditor's report on the financial statements that include the estimated military postretirement health benefits liabilities had not been issued as of the date of our audit report.¹ 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, weaknesses in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as 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, if 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 weaknesses in reporting assets and liabilities, material weaknesses 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

¹The auditor's report on these financial statements was issued subsequent to the date of our audit report. The auditor continued to report issues related to the cost of direct health care provided by DOD-managed military treatment facilities.

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 2007 and 2006, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and Treasury's 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. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in *The Budget of the United States Government* (hereafter referred to as "the President's Budget") concerning obligations and outlays.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. 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 adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, 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 as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting

methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

Preparation of Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2007, 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, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). In addition, as discussed in our scope limitation section of our audit report, Treasury could not provide the final fiscal year 2007 accrual basis consolidated financial statements and adequate supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2007 audit, we found the following:

- Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.
- At the federal agency level, for fiscal year 2007, auditors for many of the CFO Act agencies reported material weaknesses or other significant deficiencies regarding agencies' financial reporting processes which, in turn, could affect the preparation of the consolidated financial statements. For example, auditors for several agencies reported that a significant number of adjustments were required to prepare the agencies' financial statements. These and other auditors are also required to separately audit financial information sent by the federal agencies to Treasury via a closing package. In connection with preparing the consolidated financial statements, Treasury had to create adjustments to correct significant errors found in agencies' audited closing package information.

- To make the fiscal years 2007 and 2006 consolidated financial statements balance, Treasury recorded net decreases of \$6.7 billion and \$11 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled “Other – Unmatched transactions and balances.”² An additional net \$2.5 billion and \$10.4 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2007 and 2006, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
- The federal government could not demonstrate that it had fully identified and reported all items needed to reconcile the operating results, which for fiscal year 2007 showed a net operating cost of \$275.5 billion, to the budget results, which for the same period showed a unified budget deficit of \$162.8 billion.
- Treasury’s elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies’ problems in handling their intragovernmental transactions. As previously discussed, amounts reported for federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. This resulted in the need for intragovernmental elimination entries by Treasury that recorded the net differences between trading partners as “Other – Unmatched transactions and balances,” in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the accrual basis consolidated financial statements.
- We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that

²Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to net operating cost, it reported this amount as a component of net operating cost in the consolidated financial statements.

Treasury had not been reporting.³ While Treasury made progress in addressing some of the remaining omitted information, there continue to be disclosures required by GAAP that are excluded from the consolidated financial statements. Also, certain material weaknesses noted in this report, for example, commitments and contingencies related to treaties and other international agreements, preclude Treasury from determining if a disclosure is required by GAAP in the consolidated financial statements and us from determining if the omitted information is material. Further, Treasury's ability to report information in accordance with GAAP will also remain impaired until federal agencies, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving inadequate or ineffective (1) documentation of certain policies and procedures; (2) management reviews of adjustments and key iterations of the financial statements, notes, and management discussion and analysis provided to GAO for audit; (3) supporting documentation for certain adjustments made to the consolidated financial statements; (4) processes for monitoring the preparation of the consolidated financial statements; and (5) spreadsheet controls.
- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, as we have reported in past years, there continue to be undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.
- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2007 financial reporting challenges it faced, such as weaknesses in Treasury's process for preparing the consolidated financial statements noted above. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication

³SFFAS No. 32, *Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"* (Washington, D.C.: Sept. 28, 2006).

to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. In addition, the federal government does not perform quarterly compilations at the governmentwide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year.

Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report a budget deficit for fiscal years 2007 and 2006 of \$162.8 billion and \$247.7 billion, respectively.⁴ The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies' Statement of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit⁵ reported in the consolidated financial statements. OMB and Treasury have continued to work with federal agencies to reduce these material unreconciled differences. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury's central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will be unknown.

In fiscal year 2007, we again noted that several agencies' auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary

⁴The budget deficit, receipts, and outlays amounts are reported in Treasury's Monthly Treasury Statement and the President's Budget.

⁵See GAO's audit report on its audit of the federal government's fiscal year 2006 financial statements that was incorporated in the *2006 Financial Report of the U.S. Government* published by Treasury. Also, see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, [GAO-04-45](#) (Washington, D.C.: Oct. 30, 2003).

**Appendix I: Material Weaknesses
Contributing to Our Disclaimer of Opinion on
the Accrual Basis Consolidated Financial
Statements**

transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses also affect the agencies' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its Combined Statement of Receipts, Outlays, and Balances,⁶ and certain amounts reported in the President's Budget.

⁶*Treasury's Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.

Appendix II: Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2007. In addition to the material weaknesses discussed in appendix I that contributed to our disclaimer of opinion on the accrual basis consolidated financial statements, we found the following three other material weaknesses in internal control.

Improper Payments

Although showing progress under OMB's continuing leadership, agencies' fiscal year 2007 reporting under the Improper Payments Information Act of 2002 (IPIA)¹ does not reflect the full scope of improper payments. For fiscal year 2007, federal agencies' estimates of improper payments, based on available information, totaled about \$55 billion.² The increase from the prior year estimate of \$41 billion³ was primarily attributable to a component of the Medicaid program reporting improper payments for the first time totaling about \$13 billion for fiscal year 2007, which we view as a positive step to improve transparency over the full magnitude of improper payments.

Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.⁴ For fiscal year 2007, four agency auditors reported noncompliance issues with IPIA related to agencies' risk assessments, sampling methodologies, implementing corrective action plans, and recovering improper payments. We also identified issues with agencies' risk assessments such as not completing risk assessments of all programs and activities or not conducting annual reviews of any programs

¹Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002). The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments, estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments.

²The \$55 billion includes 19 newly reported programs with improper payment estimates totaling about \$16 billion. Of the 19 programs, 5 reported zero improper payment estimates for fiscal year 2007.

³In their fiscal year 2007 Performance and Accountability Reports (PAR), selected federal agencies updated their fiscal year 2006 improper payment estimates to reflect changes since issuance of their fiscal year 2006 PARs. These updates decreased the governmentwide improper payment estimate for fiscal year 2006 from \$42 billion to \$41 billion.

⁴GAO, *Improper Payments: Agencies' Efforts to Address Improper Payment and Recovery Auditing Requirements Continue*, [GAO-07-635T](#) (Washington, D.C.: Mar. 29, 2007).

and activities. OMB's current guidance allows for annual risk assessments to be conducted less often than annually (generally every 3 years) for programs where baselines are already established, are in the process of being measured, or are scheduled to be measured by an established date. For fiscal year 2007, we noted that 4 agencies were implementing a 3-year cycle for conducting risk assessments. Furthermore, select agencies have not reported improper payment estimates for 14 risk-susceptible federal programs with total program outlays of about \$170 billion for fiscal year 2007. Lastly, we found that major management challenges and internal control weaknesses continue to plague agency operations and programs susceptible to significant improper payments. For example, in the Department of Education's fiscal year *2007 Performance and Accountability Report*, the Office of Inspector General reported that its recent investigations continue to uncover problems, including inadequate attention to improper payments and failure to identify and take corrective action to detect and prevent fraudulent activities by grantees.

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. During fiscal year 2007, federal agencies did not consistently implement effective controls to prevent, limit, or detect unauthorized access to computing resources. Specifically, agencies did not always (1) identify and authenticate users to prevent unauthorized access; (2) enforce the principle of least privilege to ensure that authorized access was necessary and appropriate; (3) apply encryption to protect sensitive data on networks and portable devices; (4) log, audit, and monitor security-relevant events; and (5) restrict physical access to information assets. In addition, agencies did not consistently configure network devices and services to prevent unauthorized access and ensure system integrity, such as patching key servers and workstations in a timely manner; assign incompatible duties to different individuals or groups so that one individual does not control all aspects of a process or transaction; and maintain or test continuity of operations plans for key information systems. Such information security control weaknesses unnecessarily increase the risk that the reliability and availability of data that are recorded in or transmitted by federal financial management systems could be compromised. 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 administration has taken important actions to improve information security, such as issuing extensive guidance on information security and requiring agencies to perform specific actions to protect certain personally identifiable information. However, until agencies effectively and fully implement agencywide information security programs, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2007, material internal control weaknesses and systems deficiencies continued to affect the federal government's ability to effectively manage its tax collection activities, an issue that has been reported in our financial statement audit reports for the past 10 years. Due to errors and delays in recording taxpayer information, payments, and other activities, 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. Moreover, the federal government did not have cost benefit information, related cost-based performance measures, or a systematic process for ensuring it is using its resources to maximize its ability to collect what is owed and minimize the disbursements of improper tax refunds. 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.

Appendix III: Fiscal Year 2007 Audit Results

Table 2: CFO Act Agencies: Fiscal Year 2007 Audit Results and Principal Auditors

CFO Act agencies	Opinion rendered by agency auditor	Agencies' auditors reported material weaknesses or noncompliance ^a	Principal auditor
Agency for International Development	Unqualified		OIG
Agriculture	Qualified	√	OIG
Commerce	Unqualified	√	KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young, LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified		Pricewaterhouse Coopers LLP
Health and Human Services	Unqualified	√	Pricewaterhouse Coopers LLP
Homeland Security	^b	√	KPMG LLP
Housing and Urban Development	Unqualified	√	OIG
Interior	Unqualified	√	KPMG LLP
Justice	Unqualified		KPMG LLP
Labor	Unqualified	√	KPMG LLP
National Aeronautics and Space Administration	Disclaimer	√	Ernst & Young, LLP
National Science Foundation	Unqualified		Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified	√	R. Navarro & Associates, Inc.
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		Pricewaterhouse Coopers LLP
State	Disclaimer	√	Leonard G. Birnbaum and Company, LLP
Transportation	Unqualified	√	OIG
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP

Source: GAO.

^aReported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

^bFor fiscal year 2007, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit; the auditor was unable to express an opinion on these two financial statements.

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