G A O
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

March 29, 2002

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

Our report on the U.S. government's consolidated financial statements for fiscal years 2001 and 2000 is enclosed. As in the 4 previous fiscal years, we were unable to express an opinion on the consolidated financial statements because of certain material weaknesses in internal control and accounting and reporting issues. These conditions prevented us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements are fairly stated in conformity with U.S. generally accepted accounting principles.

Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard certain significant assets and properly record various transactions.

Progress is being made in addressing impediments to an opinion on the U.S. government's consolidated financial statements. For example, in fiscal year 2001, the Department of Agriculture and certain other key agencies made significant improvements in estimating the cost of the government's lending programs and the net loan amounts expected to be collected, which had contributed to our disclaimer of opinion in prior years. However, many of the pervasive and generally long-standing material weaknesses we have reported for the past 4 years remain to be fully resolved. The underlying causes of these issues are significant financial management systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control.

Across government, there are financial management improvement initiatives that, if effectively implemented, will improve the quality of the government's financial management and reporting. For fiscal year 2001, 18 of the 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same number of agencies as last year and up from 6 agencies for fiscal year 1996. Also, the Office of Management and Budget (OMB) reported that, for the second consecutive year, all 24 CFO Act agencies met the statutory reporting deadline. Further, two agencies that did not receive unqualified opinions from their auditor last year were able to do so this year, including the Department of Justice, which received an unqualified opinion for the first time. However, two other agencies were unable to sustain the unqualified opinions received from their auditor last year. Additionally, reports of inspectors general and their contract auditors indicated that only 3 of the 24 CFO Act agencies had neither a material control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

The largest impediment to an opinion on the consolidated financial statements continues to be the Department of Defense's (DOD) serious financial management problems, which we have designated as high-risk since 1995. DOD faces financial management problems that are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls. Overhauling financial management represents a major management challenge that goes far beyond financial accounting to the very fiber of the department's business operations and management culture. Cultural resistance to change and military service parochialism have played a significant role in impeding previous attempts to implement broad-based management reforms at DOD. The department has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization, and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures. In September 2001, Secretary of Defense Rumsfeld announced a broad, top-priority initiative intended to transform the full range of the department's business processes, including decades-old financial systems that are not well interconnected.

Two other major impediments that must be overcome are the government's inability to account for billions of dollars of transactions between federal government entities and to properly prepare the consolidated financial statements. The heart of the intragovernmental transactions issue is that the government lacks clearly articulated business rules for these transactions so that they are handled consistently by agencies. Compounding this problem, agencies have not reconciled intergovernmental balances with their trading partners. As a result, information reported to the Department of the Treasury (Treasury) is not reliable. OMB and Treasury have initiatives underway to address this issue. With respect to properly preparing the consolidated financial statements, Treasury plans to develop a new system and procedures to prepare the financial statements. The continued leadership of both OMB and Treasury will be important to resolve both of these issues.

Many agencies have been able to obtain unqualified audit opinions only by expending significant resources to use extensive ad hoc procedures and making billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. Also, irrespective of the unqualified opinions on their financial statements, many agencies do not have timely, accurate, and useful financial information, including cost data, and sound controls with which to make informed decisions and to ensure accountability on an ongoing basis. Auditors for 17 of the 24 CFO Act agencies reported at least one material control weakness. In addition, reports of inspectors general and their contract auditors indicated that 20 of the 24 CFO Act agencies' financial management systems were not in substantial compliance with FFMIA's three federal financial management systems requirements. For the remaining four CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMIA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMIA's requirements, which we believe is required under the statute. Ultimately, to fully meet the goals of financial management reform legislation, agencies will need to be able to generate timely, accurate, and useful financial and management information, including reporting performance results, to make decisions and monitor government performance every day. Agencies will also need to have effective internal controls in place and must ensure compliance with applicable laws and regulations.

The President's Management Agenda Fiscal Year 2002 includes improved financial management performance as one of his five governmentwide management goals. Other governmentwide initiatives include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration. These initiatives cannot be addressed in an isolated or piecemeal fashion, but must be addressed in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies. The administration plans to use the Executive Branch Management Scorecard, which includes broad standards, to highlight agencies' progress in achieving management and performance improvements embodied in *The President's Management Agenda Fiscal Year 2002*. This is a step in the right direction to improving management and performance, but the value of the scorecards is not in the scoring, but in the degree to which scores lead to sustained focus and demonstrable improvements. It will be important that there be continued rigor in the scoring process.

In August 2001, the Principals of the Joint Financial Management Improvement Program (JFMIP)—Secretary of the Treasury O'Neill, Office of Management and Budget Director Daniels, Office of Personnel Management Director James, and I, as Comptroller General of the United States—began a series of periodic meetings that have resulted in substantive deliberations and agreements focused on key financial management reform issues such as better defining measures for financial management success. These measures include being able to routinely provide timely, accurate, and useful financial information and having no material internal control weaknesses or material noncompliance with laws and regulations and FFMIA requirements, which is essential to meeting the CFO Act's expectations, *The President's Management Agenda Fiscal Year 2002*, and Secretary of Defense Rumsfeld's business process transformation initiative. In addition, the JFMIP Principals have agreed to significantly accelerate financial statement reporting so that the government's financial statements are more timely and to discourage costly efforts designed to obtain unqualified opinions on financial statements without addressing underlying systems challenges.

Federal agencies have started to make progress in their efforts to modernize their financial management systems. However, the need for timely, accurate, and useful financial and performance management information is greater than ever given the increasing demands on the federal budget.[1] Indeed, the challenges of combating terrorism and ensuring our homeland security have come to the fore as urgent claims on our attention and on the federal budget. At the same time, the known fiscal pressures created by the retirement of the baby boom generation and rising health care costs remain. Correspondingly, the ultimate task of addressing today's needs without unduly exacerbating the long-range fiscal challenge has become much more difficult.

As we look ahead we face an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. In fact, in 2008—only 6 years from now—the first wave of baby boomers become eligible to claim their Social Security benefits. As the share of the population over 65 climbs to more than 20 percent in 2035, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Absent substantive reform of these entitlement programs, a rapid escalation of federal spending for Social Security, Medicare, and Medicaid is virtually certain to overwhelm the rest of the federal budget.

On March 26, 2002, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees' reports highlight the need to address the long-term fiscal challenges facing the nation. The Trustees state that, while the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon. Once again, the Trustees underscored the fact that the most significant implication of these findings is that both Social Security and Medicare need to be reformed and strengthened at the

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[1] Additionally, as of March 20, 2002, when we completed our field work, Treasury officials were anticipating that the current $5,950 billion debt ceiling for the government could be reached in the near future. Treasury officials were monitoring the situation closely and contemplating taking appropriate action if warranted, including exercising certain statutory authorities available to the Secretary of the Treasury.

earliest opportunity. The Trustees also stated that Medicare faces financial difficulties that in many ways are more severe than those confronting Social Security.

These long-term demographic and fiscal pressures and the new commitments undertaken after September 11 sharpen the need to look at competing claims and new priorities. While reforming health and retirement entitlement programs is essential to preserving fiscal flexibility in the long term, a fundamental review of all programs and operations can create much-needed fiscal flexibility to address emerging needs. There is a need to consider what the proper role of the federal government will be in the 21st century and how the government should do business in the future.

Timely, accurate, and useful financial and performance information can form the basis for reconsidering the relevance or "fit" of any federal program or activity in today's world and for the future. Such a review might identify programs that have proven to be outdated or persistently ineffective, or alternatively could prompt us to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering of processes and operations. In addition, the review should not be limited to only spending programs but should include the full range of more indirect tools of governance that the federal government uses to address national objectives. These tools include loans and loan guarantees, tax expenditures, and regulations. Ultimately, we should strive to hand to the next generation the legacy of a government that is effective and relevant to a changing society—a government that is as free as possible of outmoded commitments and operations that can inappropriately encumber the future.

The Congress and President Bush face the challenge of sorting out these many claims on the federal budget without the fiscal benchmarks that guided us through the years of deficit reduction into surplus. Going forward, new rules and goals will be important both to ensure fiscal discipline and to prompt a focus on the longer term implications of decisions. It is still the case that the federal government needs a decision-making framework that permits it to evaluate choices against both today's needs and the longer term fiscal future that will be handed to future generations. As stewards of our nation's future, we must begin to prepare for tomorrow. In this regard, we must determine how best to address these structural challenges in a reasonably timely manner in order to identify specific actions that need to be taken.

We appreciate the cooperation and assistance of Department of the Treasury and OMB officials, as well as the chief financial officers and inspectors general in carrying out our responsibility to report on the U.S. government's consolidated financial statements. We look forward to continuing to work with these officials and the Congress to achieve the goals and objectives of financial management reform.

Our report was prepared under the direction of Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-2600.

David M. Walker
Comptroller General
of the United States

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The President
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The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required annually to submit financial statements for the U.S. government to the President and the Congress. GAO is required to audit these statements.[1] This is our report on the accompanying U.S. government's consolidated financial statements for the fiscal years ended September 30, 2001 and 2000[2] and associated reports on internal control and compliance with laws and regulations.

The government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act are met,[3] and (3) complying with applicable laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies are responsible for implementing and maintaining financial management systems that comply with the Federal Financial Management Improvement Act's (FFMIA) requirements. Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2001 and 2000. Appendix I discusses the scope and methodology of our work.

A significant number of material weaknesses[4] related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to (1)

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[1]The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331 (e). The government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.
[2]The consolidated financial statements for the fiscal years ended September 30, 2001 and 2000 consist of the Statements of Operations and Changes in Net Position, the Statements of Net Cost, the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), the Dispositions of the Budget Surplus (Unaudited), and Balance Sheets, including the related notes to these financial statements and Stewardship Information (Unaudited).
[3]31 U. S. C. 3512 (c), (d). This Act requires agency heads to evaluate and report annually to the President on the adequacy of their internal controls and accounting systems and on actions to correct significant problems.
[4]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard significant assets and properly record various transactions. Several of these material weaknesses (referred to hereafter as material deficiencies) resulted in conditions that continued to prevent us from expressing an opinion on the accompanying consolidated financial statements for the fiscal years ended September 30, 2001 and 2000.[5] There may also be additional issues that could affect the consolidated financial statements that have not been identified.

This year, upon early implementation of certain provisions of the National Defense Authorization Act for fiscal year 2002, the Department of Defense (DOD) reported that DOD's financial management systems are not able to provide adequate evidence supporting material amounts in its financial statements. DOD asserted that it is unable to comply with applicable financial reporting requirements for (1) property, plant, and equipment, (2) inventory and operating materials and supplies, (3) military retirement health care actuarial liability, (4) environmental liabilities, (5) intragovernmental eliminations and related accounting adjustments, and (6) cost accounting by suborganization/responsibility segment and major program.

Based largely on DOD's assertion, the DOD inspector general disclaimed an opinion on DOD's financial statements for fiscal year 2001 as it did for the previous 5 fiscal years. DOD's financial management systems and reporting weaknesses substantially impair our ability to determine the reliability of the financial information reported in the government's overall financial reports. Until DOD corrects these material weaknesses, they will continue to impede our ability to express an opinion on the U.S. government's consolidated financial statements. In addition, as noted later in this report, there are other material weaknesses that need to be corrected.

For the fiscal year 2001 *Financial Report of the United States Government*, the government has for the first time presented: (1) comparative financial statements;[6] (2) two new financial statements, namely, the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), and the Dispositions of the Budget Surplus (Unaudited); and (3) a Statement of Net Cost that arrays information classified by agency rather than by function, as was shown in prior years.

DISCLAIMER OF OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

Because we were unable to determine the reliability of significant portions of the accompanying U.S. government's consolidated Statements of Operations and Changes in

[5] We previously reported that material deficiencies prevented us from expressing an opinion on the fiscal year 1997, 1998, and 1999 consolidated financial statements.

[6] Numerous amounts previously reported for fiscal year 2000 have been restated in the accompanying consolidated financial statements. Given our disclaimer of opinion on the fiscal year 2000 consolidated financial statements and because the dollar amounts involved were not material, we did not audit these changes.

Net Position, Statements of Net Cost and Balance Sheets, for the fiscal years ended September 30, 2001 and 2000, we are unable to, and we do not, express an opinion on these consolidated financial statements. The Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus and the Dispositions of the Budget Surplus were not audited by us and, accordingly, we do not express an opinion on them.

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

We have not audited and do not express an opinion on the Stewardship Information and Supplemental or Other Information included in the accompanying fiscal year 2001 *Financial Report of the United States Government*.[7]

Material Deficiencies

The government did not maintain adequate systems or have sufficient, reliable information to support information reported in the accompanying consolidated financial statements as described below. These material deficiencies contributed to our disclaimer of opinion and also constitute material weaknesses in internal control. Unless otherwise noted, the deficiencies existed for both fiscal year 2001 and 2000. Appendix II highlights the primary effects of these material weaknesses on the accompanying consolidated financial statements and on the management of government operations.

Property, Plant, and Equipment and Inventories and Related Property The government could not: satisfactorily determine that all such assets were included in the consolidated financial statements, verify that certain reported assets actually exist, or substantiate the amounts at which they were valued. A majority of the property, plant, and equipment and inventories and related property is the responsibility of DOD. Certain agencies, including DOD, did not maintain adequate systems or have sufficient records to provide reliable information on these assets.

Loans Receivable and Loan Guarantee Liabilities For fiscal year 2000, certain federal credit agencies responsible for significant portions of the government's lending programs, most notably the Department of Agriculture (USDA), were unable to properly estimate the cost of these programs, or estimate the net loan amounts expected to be collected, in conformity with U.S. generally accepted accounting principles and budgeting requirements. In fiscal year 2001, USDA and other key agencies made

[7] Although not required by U.S. generally accepted accounting principles to be reported in the consolidated financial statements, in prior years, the government reported certain significant information related to national defense assets in Stewardship Information. The government did not report such information in the accompanying consolidated financial statements.

significant improvements to these estimates, and as a result, this item is not a material deficiency contributing to our disclaimer of opinion on the fiscal year 2001 consolidated financial statements. However, significant adjustments to the initial estimates of program costs, net loan amounts to be collected, and related footnotes were required during the audit process at certain key agencies, indicating that material internal control weaknesses continue to exist in processes and procedures for making such estimates.

Liabilities and Commitments and Contingencies The government could not adequately support amounts reported for certain liabilities. For example, it could not develop an accurate estimate of key components of DOD's environmental and disposal liabilities and accurately estimate military postretirement health benefits liabilities included in federal employee and veteran benefits payable, which were reported at $581 billion in fiscal year 2001 and $192 billion in fiscal year 2000. In addition, the government could not determine whether commitments and contingencies, including those related to treaties and other agreements entered into to further the U. S. government's interests, were complete and properly reported.

Cost of Government Operations and Disbursement Activity The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of effective agency disbursement reconciliations affect reported net costs. As a result, the government was unable to support significant portions of the total net cost of government operations, most notably related to DOD and USDA. As it relates to disbursement reconciliations, several major agencies did not effectively reconcile disbursements to the Department of the Treasury's (Treasury) records of disbursements, which is intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner. This is similar in concept to individuals reconciling their checkbooks with their bank statements each month. Although we have seen progress in this area over the past 5 years, there continued to be billions of dollars of unreconciled differences between agencies' and the Treasury's records of disbursements as of September 30, 2001 and 2000, which could also affect the balance sheet.

Accounting for and Reconciliation of Intragovernmental Activity and Balances For several years, OMB and Treasury have required the CFO Act agencies to reconcile selected intragovernmental activity and balances with their "trading partners."[8] However, numerous agencies did not fully perform such reconciliations for fiscal year 2000. Beginning with fiscal year 2001, OMB and Treasury required agency chief financial officers to report on the extent and results of intragovernmental activity and balances reconciliation efforts. The inspectors general reviewed these reports and communicated the results of their reviews to OMB, Treasury, and GAO. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for fiscal year 2001 citing reasons such as (1) trading partners not providing needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resource issues. For fiscal years 2001 and 2000, amounts reported for agency trading partners for certain

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

intragovernmental accounts were significantly out of balance. In addition, solutions will be required to resolve significant differences reported in other intragovernmental accounts, primarily related to appropriations.

To help address certain issues that contributed to the out of balance condition for intragovernmental activity and balances, OMB has stated that it is implementing the recommendations included in a study conducted for the Joint Financial Management Improvement Program in fiscal year 2001. OMB is also pursuing other changes to address core problems in this area, such as enhancing governmentwide business rules for transactions among trading partners, requiring quarterly reconciliations of intragovernmental activity and balances, and modifying certain standard general ledger accounts required to be used by federal agencies. Resolving this problem remains a difficult challenge and will require a commitment by the CFO Act agencies and continued strong leadership by OMB.

<u>Preparation of Consolidated Financial Statements</u> The government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements, as described below. Also, disclosure of certain financial information was not presented in the consolidated financial statements in conformity with U.S. generally accepted accounting principles.

> *<u>Elimination of Intragovernmental Activity and Balances</u>* Consolidated financial statements are intended to present the results of operations and financial position of the components that comprise a reporting entity as if the entity were a single enterprise. When preparing the consolidated financial statements, the preparer must eliminate intragovernmental activity and balances between the agencies. Because of agencies' problems in handling their intergovernmental transactions, Treasury's ability to eliminate these transactions is impaired. Significant differences reported in intragovernmental accounts as noted above have been identified. Intragovernmental activity and balances are "dropped" or "offset" in the preparation of the consolidated financial statements rather than eliminated through balanced accounting entries. This contributes to the government's inability to determine the impact of these differences on amounts reported in the consolidated financial statements.
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> *<u>Reconciling Operating Results With Budget Results</u>* The government did not have a process to effectively identify and report items needed to reconcile adequately the operating results, which for fiscal year 2001 showed a net operating cost of $514.8 billion, to the budget results, which for the same period showed a unified surplus of $127 billion.
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> *<u>Consolidated Financial Statement Compilation</u>* The government could not adequately ensure that the information for each agency that was included in the consolidated financial statements was consistent with the underlying agency financial statements. This problem is compounded by the need for broad changes in the structure of the government's Standard General Ledger (SGL) accounts and the process for maintaining the SGL. For example, changes are needed that will result in direct alignment by SGL account from agencies' financial statement line items to like items reported in the consolidated financial statements.

To make the fiscal year 2001 consolidated financial statements balance, Treasury recorded a net $17.3 billion decrease to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. For the prior fiscal year, a net $4.8 billion in unreconciled transactions was recorded as a decrease to net operating revenue in the accompanying consolidated financial statements.[9] An additional net $3.9 billion and $.2 billion of unreconciled transactions were improperly recorded in net cost for fiscal years 2001 and 2000, respectively. Treasury attributes these net unreconciled transaction amounts primarily to the government's inability to properly identify and eliminate transactions between governmental entities, agency adjustments that affected net position, and other errors. However, Treasury was unable to adequately identify and explain the gross components of such amounts. Unreconciled transactions also may exist because the government does not have effective controls over reconciling net position.[10]

The net position reported in the consolidated financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. Further, the process used to prepare the consolidated financial statements requires significant human and financial resources and does not adequately leverage the existing work and work products resulting from federal agencies' audited financial statements.

Treasury plans to develop a new system and procedures to prepare the consolidated financial statements. These actions are intended to, among other things, directly link information from agencies' financial statements to amounts reported in the consolidated financial statements and facilitate the reconciliation of net position.

ADVERSE OPINION ON INTERNAL CONTROL

In addition to the material weaknesses noted above, we found three other material weaknesses in internal control as of September 30, 2001, which are described below. Because of the effects of the material weaknesses discussed in this report, in our opinion, the government did not maintain effective internal control to meet the following objectives: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and stewardship information in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and stewardship information. Individual agency financial statement audit reports identify

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[9] Last year a net $7.3 billion in unreconciled transactions was recorded as an increase in net position. As discussed in footnote 6 in this report, numerous amounts previously reported for fiscal year 2000 have been restated in the accompanying financial statements, including this amount.

[10] In prior years, the government reported unreconciled transactions as a change in net position. Although the government was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating revenue/ (cost) in the accompanying consolidated financial statements.

additional reportable conditions[11] in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These matters do not represent material weaknesses at the governmentwide level. Also, due to the issues noted throughout this report, additional material weaknesses may exist that have not been reported.

<u>Improper Payments</u> Across government, improper payments[12] occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds. These payments often result from a lack of or an inadequate system of internal controls. Many federal programs are administered by entities other than the federal government. Most agencies have not estimated or reported the magnitude of improper payments in their programs.[13] *The President's Management Agenda Fiscal Year 2002* includes addressing erroneous payments (a term we consider synonymous with improper payments) as one of the two key elements for improving financial performance. While reported estimates of improper payments totaled approximately $19 billion for both fiscal years 2001 and 2000, the government did not estimate the full extent of improper payments in the consolidated financial statements. However, OMB now requires agencies to provide information on erroneous payment rates for directly administered federal programs over $2 billion.

<u>Computer Security</u> GAO has reported computer security as a governmentwide high-risk area since February 1997.[14] Computer security weaknesses are placing enormous amounts of government 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. The government is not in a position to estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are either not detected or not reported. Agencies have not yet established comprehensive security management programs, which would provide the government with a framework for resolving computer security problems and managing computer security risks on an ongoing basis. The initial implementation of government information security reform provisions contained in the National Defense Authorization Act for fiscal year 2001, is a significant step in improving federal agencies' information security programs and addressing their serious, pervasive information security weaknesses. In its first report on the reform provisions, OMB commended agencies' improvement efforts, but noted that many agencies have significant deficiencies in every important area of security.

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[11] Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the government's ability to meet the internal control objectives described in this report.

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

[13]U.S. General Accounting Office, *Financial Management: Improper Payments Reported in Fiscal Year 2000 Financial Statements,* GAO-02-131R (Washington, D.C.: Nov. 2, 2001).

[14]See, for example, U.S. General Accounting Office, *High-Risk Series: An Update,* GAO-01-263 (Washington, D.C.: Jan. 2001).

Tax Collection Activities Material internal control weaknesses and systems deficiencies continue to affect the government's ability to effectively manage its tax collection activities.[15] Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the 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 government.

COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS AND FFMIA REQUIREMENTS

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited by the material weaknesses discussed above. Instances of noncompliance, some of which the agency auditors reported were material to individual agency financial statements, are included in individual agency audit reports. However, none of these instances were material to the accompanying consolidated financial statements.

Additionally, FFMIA requires auditors, as part of CFO Act agency financial statement audits, to report whether agencies' financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards (U.S. generally accepted accounting principles), and the government's standard general ledger at the transaction level. For fiscal year 2001, auditors for 20 of the CFO Act agencies reported that agencies' financial management systems did not substantially comply with one or more of FFMIA's three requirements. For the remaining four CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMIA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMIA's requirements, which we believe is required under the statute. While agencies continue to make some progress in addressing their financial management systems weaknesses, the serious shortcomings reported for these systems result in the lack of reliable financial information day-to-day that hampers effective financial management and is critical for implementation of the Government Performance and Results Act and the transition to a more results-oriented federal government. GAO plans to report to the Congress, by October 1, 2002, on agencies' FFMIA implementation for fiscal year 2001, as also required by FFMIA.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

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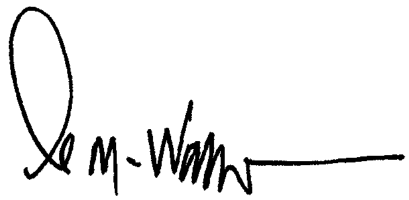
[15] U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements,* GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

We provided a draft of this report to Department of the Treasury and Office of Management and Budget officials, who expressed their commitment to address the problems this report outlines.



David M. Walker
Comptroller General
of the United States

March 20, 2002

APPENDIX I

SCOPE AND METHODOLOGY

The Government Management Reform Act of 1994 expanded the requirements of the CFO Act by making the inspectors general of 24 major federal agencies responsible for annual audits of agencywide financial statements prepared by these agencies and GAO responsible for the audit of the U.S. government's consolidated financial statements.[16] Our work was performed in coordination and cooperation with the inspectors general to achieve our joint audit objectives. This work included separate GAO audits of certain material agency components, as discussed below. Our audit approach focused primarily on determining the current status of the material deficiencies and the other material weaknesses affecting internal control that we had previously reported in our report on the consolidated financial statements for fiscal year 2000.[17] We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and the results of our assessment of compliance with applicable laws and regulations.

We separately audited the following material agency components.

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2001 and 2000 financial statements, which included approximately $2.1 trillion of tax revenue each year and $251 and $194 billion of tax refunds, and $20 billion and $22 billion of net federal taxes receivable for fiscal year 2001 and 2000, respectively.[18] In fiscal year 2001, we continued to report numerous material internal control weaknesses, which resulted in ineffective internal controls. We also reported one instance of noncompliance with applicable laws and regulations and lack of substantial compliance of IRS' financial management systems with FFMIA.

- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2001 and 2000.[19] The schedules reported for these 2 fiscal years (1) over $3.3 (2001) and $3.4 (2000) trillion of federal debt held by the public comprising individuals, corporations, state and local governments, the Federal Reserve Banks, and foreign governments and central banks, (2) about $2.5 (2001) and $2.2 (2000) trillion of intragovernmental debt holdings, which represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds, and (3) nearly $207 (2001) and $225 (2000) billion of interest on federal debt held by the public.[20] In fiscal year 2001, we

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[16]The 1994 Act authorized OMB to designate agency components that also would receive a financial statement audit.

[17] U.S. General Accounting Office, *U.S. Government Financial Statements: FY 2000 Reporting Underscores the Need to Accelerate Federal Financial Management Reform*, GAO-01-570T (Washington, D.C.: Mar. 30, 2001).

[18]GAO-02-414.

[19]U.S. General Accounting Office, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2001 and 2000 Schedules of Federal Debt,* GAO-02-354 (Washington, D.C.: Feb. 15, 2002).

[20] Treasury anticipates that the current debt ceiling of $5,950 billion could be reached in early 2002, and if so, appropriate action will need to be taken.

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reported that BPD had effective internal control over financial reporting and compliance with laws and regulations related to the Schedules of Federal Debt. Further, we reported that there was no reportable noncompliance with a selected provision of a law we tested.

- We audited and expressed unqualified opinions on the December 31, 2000 and 1999 financial statements of the funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund.[21] We reported that as of December 31, 2000, FDIC had effective internal control over financial reporting and compliance with laws and regulations. In addition, we performed audit procedures and tests of internal control over cash, investments and earned interest, and other material balances of the funds administered by FDIC as of September 30, 2001.

For fiscal year 2000, we performed tests of cash balances maintained by Treasury on behalf of the government. We provided the results of our work to the Treasury Office of Inspector General for consideration in its audit of Treasury's fiscal year 2000 departmentwide financial statements. For fiscal year 2001, the Treasury Office of Inspector General performed tests of cash balances.

We considered the CFO Act agencies' and certain other agencies' fiscal years 2001 and 2000 financial statements and the related auditors' reports prepared by the inspectors general or their contractors. Financial statements and audit reports for these agencies provide information about the operations of each of these entities. We did not audit, and we do not express an opinion on, any of these individual agency financial statements. We also considered the Department of Defense assertion provided to the DOD inspector general that DOD management prepared and submitted pursuant to the provisions of the National Defense Authorization Act for fiscal year 2002. We performed our work in accordance with U.S. generally accepted government auditing standards.

[21] U.S. General Accounting Office, *Financial Audit: Federal Deposit Insurance Corporation's 2000 and 1999 Financial Statements,* GAO-01-635 (Washington, D.C.: May 9, 2001).

APPENDIX II

Primary Effects Caused by the Material Weaknesses and FFMIA Noncompliance Described in This Report

Areas Involving Material Weaknesses and FFMIA Noncompliance	Primary Effects on the Fiscal Year 2001 and 2000 Consolidated Financial Statements and the Management of Government Operations
Property, plant, and equipment and inventories and related property	Without accurate asset information, the 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 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	Weaknesses in the processes and procedures for estimating credit program costs affect the government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.
Liabilities	Problems in accounting for liabilities affect the determination of the full cost of the government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the government's ability to determine priorities for cleanup and disposal activities and to allow for appropriate consideration of future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the government's obligations.
Cost of government operations and disbursement activity	Inaccurate cost information affects the government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by agencies for inclusion in the president's budget concerning obligations and outlays.
Accounting for and reconciliation of intragovernmental activity and balances	Problems in accounting for and reconciling intragovernmental activity and balances impair the government's ability to account for billions of dollars of transactions between governmental entities.
Preparation of consolidated financial statements	Weaknesses related to the preparation of the consolidated financial statements impair the government's ability to (1) effectively identify and report items needed to reconcile adequately the operating results reported in the consolidated financial statements with budget results, and (2) fully ensure that the consolidated financial statements were consistent with agency financial statements and were properly balanced.
Improper payments	Without a systematic measurement of the extent of improper payments, agency management cannot determine (1) if the problem is significant enough to require corrective action, (2) how much to invest in preventive internal control, (3) the success of efforts implemented to reduce improper payments, or (4) the magnitude or trends of improper payments, which limits the ability to pinpoint or target mitigation strategies.
Computer security weaknesses	Computer security weaknesses are placing enormous amounts of federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption.
Tax collection activities	Weaknesses in controls over tax collection activities continue to affect the government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting affect the government's ability to make informed decisions about collection efforts. As a result, the government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.
FFMIA	When agency financial systems lack substantial compliance with FFMIA requirements, reliable financial information is not available for effective decision-making day to day.

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