United States General Accounting Office

GAO

Report to the Secretary of the Treasury and the Director of the Office of Management and Budget

October 2003

FINANCIAL AUDIT

Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement

GAO-04-45

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-04-45, a report to the Secretary of the Treasury and the Director of the Office of Management and Budget

Why GAO Did This Study

For the past 6 years, since GAO began auditing the consolidated financial statements of the U.S. government (CFS), GAO has been unable to express an opinion on them because of material weaknesses in internal control and financial reporting. Contributing to GAO's inability to express an opinion has been the federal government's lack of adequate systems, controls, and procedures to properly prepare its consolidated financial statements.

The purpose of this report is to discuss in greater detail weaknesses in financial reporting procedures and internal control over the process for preparing the CFS that GAO identified and to recommend improvements to address those weaknesses.

What GAO Recommends

GAO makes 44 recommendations to address weaknesses identified, including a recommendation that Treasury, in coordination with the Office of Management and Budget (OMB), design its new compilation process to directly link information from federal agencies' audited financial statements to amounts reported in the CFS. GAO also makes 16 recommendations that address CFS disclosures required by U.S. generally accepted accounting principles. Treasury and OMB stated that many of our recommendations will improve the usefulness and accuracy of the CFS, but disagreed with recommendations in two areas.

www.gao.gov/cgi-bin/getrpt?GAO-04-45.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gary T. Engel at (202) 512-3406 or engelg@gao.gov.

What GAO Found

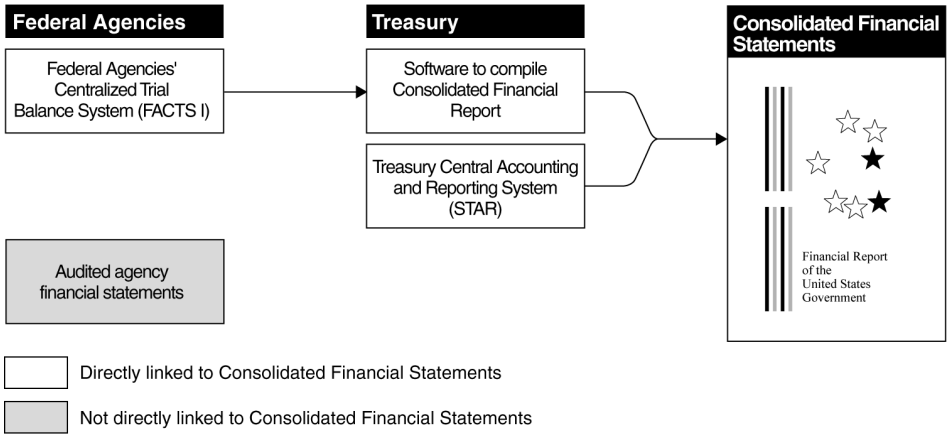
GAO found deficiencies in the compilation and reporting process in the following areas:

- controls over the compilation process,
- unreconciled transactions affecting the change in net position,
- reconciliation of intragovernmental activity and balances,
- elimination of intragovernmental activity and balances,
- reconciliation of net operating costs and unified budget surplus (or deficit),
- statements of changes in cash balance from unified budget and other activities,
- defining and documenting of the reporting entity, and
- conformity with U.S. generally accepted accounting principles.

Another key deficiency in the compilation and reporting process for the CFS was the failure of the Department of the Treasury's process for compiling the CFS to directly link information from federal agencies' audited financial statements to amounts reported in the CFS (see figure below). Without this direct link, the information in the CFS may not be reliable. The lack of a direct link also affects the efficiency and effectiveness of the CFS audit. Treasury is designing a new compilation process that it expects to directly link this information beginning with the fiscal year 2004 CFS.

GAO identified three additional areas related to the compilation and reporting process for the CFS that warrant the attention of Treasury and the Office of Management and Budget: (1) management representation letters, (2) legal representation letters, and (3) information on treaties and other international agreements.

Lack of Direct Link between Audited Agency Financial Statements and the CFS



Source: GAO.

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United States General Accounting Office
Washington, D.C. 20548

October 30, 2003

The Honorable John W. Snow
The Secretary of the Treasury

The Honorable Joshua B. Bolten
Director, Office of Management and Budget

In March 2003, we issued our disclaimer of opinion on the consolidated financial statements for the U.S. government (CFS) for the fiscal years ended September 30, 2002 and 2001. For the past 6 years, certain material weaknesses in internal control and in financial reporting resulted in conditions that prevented us from expressing an opinion on the CFS. Specifically, we have reported that the federal government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements. Many of these weaknesses in internal control that contributed to our disclaimer of opinion were identified during the audit of federal agencies' financial statements by the agency financial statement auditors and reported in detail with recommendations to the agencies in separate reports. However, some of the internal control weaknesses were identified during our tests of the U.S. Department of the Treasury's (Treasury) process for preparing the CFS. Such weaknesses impaired the federal government's ability to fully ensure that the CFS is consistent with the underlying audited agency financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles. Consequently, these weaknesses also contributed to our inability to render an opinion on the CFS.

The purpose of this report is to discuss in greater detail weaknesses we identified during our fiscal year 2002 audit regarding financial reporting procedures and internal control over the process for preparing the CFS. We have discussed each of these weaknesses with your staff during this past audit, and some of the weaknesses have been communicated for a number of years.

Results in Brief

The deficiencies in the compilation and reporting processes involve the following nine areas: (1) directly linking audited agency financial statements to the CFS, (2) controls over the compilation process, (3) unreconciled transactions affecting the change in net position, (4) reconciliation of intragovernmental activity and balances, (5) elimination of intragovernmental activity and balances,

(6) reconciliation of net operating costs and unified budget surplus (or deficit), (7) statements of changes in cash balance from unified budget and other activities, (8) defining and documenting of the reporting entity, and (9) conformity with U.S. generally accepted accounting principles.

We also identified and discuss in this report certain issues related to (1) management representation letters, (2) legal representation letters, and (3) information on treaties and other international agreements that will require actions by Treasury and the Office of Management and Budget (OMB). Other issues related to these three areas need to be addressed by federal agencies and their auditors. We plan to separately communicate to agency Chief Financial Officers (CFO) and Inspectors General the details of our concerns regarding these issues.

This report includes 44 recommendations to address weaknesses we identified. It also includes recommendations related to 16 disclosures identified in appendix I that are required by U.S. generally accepted accounting principles. We are recommending that these 16 disclosures that are not included in the most recent CFS either be included or that the rationale for their exclusion be documented.

Treasury and OMB stated that many of our recommendations will improve the usefulness and accuracy of the CFS and that they have already incorporated many of them into their new system and processes that are being developed for preparing the fiscal year 2004 CFS. However, Treasury and OMB disagreed with our recommendations related to unreconciled transactions affecting net position and the Statement of Changes in Cash Balance from Unified Budget and Other Activities.

In response to their concerns and recognizing that there are various ways to correct an identified weakness, we modified our recommendation related to unreconciled transactions affecting net position to be less prescriptive as to the action to take, but retained the intent of our proposed recommendation. Treasury and OMB also disagreed with what they perceived as our recommendation to use agency data to prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities. They disagreed with that approach because they stated that it would be time consuming and costly, and they prefer to obtain the information from Treasury's central accounting system rather than from agencies' financial statements. This is not what we recommended. Instead, because we found unexplained material differences between Treasury's records and some agencies' financial statements, we

recommended that Treasury collect certain information already reported in federal agencies' audited financial statements and develop procedures that ensure consistency of the significant line items on the Statement of Changes in Cash Balance from Unified Budget and Other Activities with the agency-reported information.

Scope and Methodology

As part of our audit of the fiscal years 2002 and 2001 CFS, we evaluated Treasury's financial reporting procedures and related internal control. In our report, which is included in the fiscal year 2002 *Financial Report of the United States Government*,[1] we reported material deficiencies relating to Treasury's financial reporting procedures and internal control. These material deficiencies contributed to our disclaimer of opinion on the CFS and also constitute material weaknesses in internal control, which contributed to our adverse opinion on internal control. We performed sufficient audit work to provide the disclaimer of opinion and issued our audit report, dated March 20, 2003, in accordance with U.S. generally accepted government auditing standards. This report is based on the audit work we performed for the fiscal years 2002 and 2001 CFS.

We requested comments on a draft of this report from the Secretary of the Treasury and the Director of OMB or their designees. Treasury's and OMB's comments are reprinted in appendix II, discussed in the Agency Comments and Our Evaluation section of this report, and incorporated in the report as applicable.

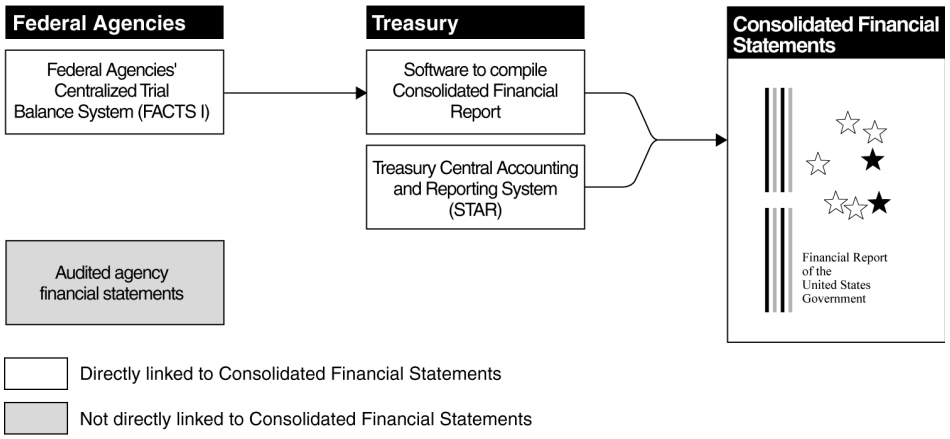
Directly Linking Audited Agency Financial Statements to the CFS

Treasury's current process for compiling the CFS does not directly link information from federal agencies' audited financial statements to amounts reported in the CFS, and therefore cannot fully ensure that the information in the CFS is consistent with the underlying information in federal agencies' audited financial statements and other financial data (see fig. 1). Treasury, as the preparer of the CFS, currently collects approximately 2,400 trial balances through the Federal Agencies' Centralized Trial Balance System (FACTS I) from federal agencies and information from the Treasury

[1]The fiscal year 2002 *Financial Report of the United States Government* was issued by the Department of the Treasury on March 31, 2003, and is available through GAO's Web site at www.gao.gov and Treasury's web site at www.fms.treas.gov/fr/index.html.

Central Accounting and Reporting System (STAR) to compile the financial statements.

Figure 1: Lack of Direct Link between Audited Agency Financial Statements and CFS



Source: GAO.

The Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Concepts No. 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*, states that the consolidated financial report should be a general purpose report that is aggregated from agency reports and that it should tell users where to find information in other formats, both aggregated and disaggregated, such as individual agency reports, agency websites, and the President's Budget.

Without directly linking financial information from agencies' audited financial statements, the information in the CFS may not be reliable. The lack of direct linkage also affects the efficiency and effectiveness of the audit of the CFS. In addition, the reliability of certain information in Management's Discussion and Analysis, Stewardship Information, and Supplemental Information may be affected.

As Treasury is designing its new compilation process, which it expects to implement beginning with the fiscal year 2004 CFS, we recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in

coordination with the Controller of OMB's Office of Federal Financial Management, to

- design the new compilation process to directly link information from federal agencies' audited financial statements to amounts reported in all the applicable CFS and related footnotes, and
- consider the other applicable recommendations in this report when designing and implementing the new compilation process.

Controls over the Compilation Process

We identified specific areas of internal control in Treasury's process for preparing the CFS that need to be strengthened. Internal control should provide, among other things, reasonable assurance that financial reporting is reliable. GAO's *Standards for Internal Control in the Federal Government*[2] defines the minimum level of quality acceptable for internal control in the federal government and provides the standards against which internal control is to be evaluated. These standards state that internal controls should include, among other items, (1) segregation of duties, (2) appropriate documentation of transactions and internal control, and (3) reviews by management at the functional or activity level. We found many controls in place, but we identified three areas that need to be improved. Although Treasury is developing a new system and procedures for preparing the CFS, the need for adequate internal control remains important and needs to be considered during the development process.

Segregation of Duties

Segregation of duties is the practice of dividing the steps in a critical function among different individuals in order to reduce the risk of error or fraud, thus preventing a single individual from having full control of a transaction or event. FACTS I and the Financial Management Service's Hyperion database are used to compile the CFS. We found that Treasury's systems administrators responsible for processing the FACTS I data have the capability to enter, change, and delete data within FACTS I and the Hyperion database without any supervisory review. They are also able to post adjustments to the CFS without formal approval. Lack of proper segregation of duties for critical functions leaves the CFS vulnerable to

[2]U.S. General Accounting Office, *Internal Control: Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

errors and could result in incomplete and inaccurate summarization of data within these financial statements.

Documentation of Transactions and Internal Control

While Treasury has documented some portions of its process for compiling the CFS, it has not fully documented its policies and procedures for preparing the CFS report. Agency management is responsible for developing detailed policies, procedures, and practices to fit agency operations and ensuring that internal control is built into and is an integral part of operations. Although GAO's *Standards for Internal Control in the Federal Government* calls for clear documentation of policies and procedures, we found that Treasury has not fully implemented this key control activity. Without documented policies and procedures, staff could follow inconsistent standards and practices or not follow them at all. This potential for inconsistency increases the risk that errors in the compilation process could go undetected and could result in an incomplete and inaccurate summarization of data within the CFS, creating a financial report that is not an accurate representation of the financial position of the U.S. government.

Management Review

We found that Treasury management did not review transactions within several key compilation processes. Transactions and other significant events should be authorized and executed only by persons acting within the scope of their authority. Appropriate reviews by management of key decisions and data are vital controls to ensure that only authorized actions occur. For example, Treasury's FACTS I system allows for master appropriation files, the files that list all federal agencies by appropriation code, to be updated by review accountants without supervisory approval. Also, there is no requirement for supervisory review of changes made to agency data as a result of issues identified during the "agency data analysis process" performed by Treasury. In some instances, supervisory reviews were required, but any reviews that may have been performed were not documented. For example, there was no documentation of supervisory review of changes to the Hyperion system software and chart of accounts used to compile the data for the CFS. Records of changes and reviews of the changes made to the templates used to create the CFS were also inadequate.

Inadequate supervisory review and inadequate documentation of changes and reviews could allow data that go into the CFS to be manipulated or changed without any supervisory control or review, resulting in the

possibility that agency data could be changed or incorrectly compiled in the CFS.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, in connection with Treasury's current compilation process and the development of Treasury's new compilation system and process, to

- segregate the duties of individuals who have the capability to enter, change, and delete data within FACTS I and the Hyperion database and post adjustments to the CFS;
- develop and fully document policies and procedures for the consolidated financial statement preparation process so that they are proper, complete, and consistently applied among staff members; and
- require and document reviews by management of all procedures that result in data changes to the CFS.

Unreconciled Transactions Affecting the Change in Net Position

The net position reported in the CFS is derived by subtracting liabilities from assets, rather than through balanced accounting entries. In other words, the CFS is "plugged" to make it balance. To make the fiscal year 2002 CFS balance, Treasury recorded a net $17.1 billion decrease to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Unreconciled Transactions Affecting the Change in Net Position." Treasury does not identify and quantify all components of this unreconciled activity.

Treasury attributes these net unreconciled transaction amounts to (1) improper recording of intragovernmental transactions by federal agencies, (2) transactions affecting assets and liabilities not being identified properly by federal agencies as prior period adjustments, and (3) timing differences and errors in reporting transactions. Treasury stated in its November 2001 report on its CFS improvement project[3] that in order to properly reconcile net position, federal agencies would need to split net position between intragovernmental and public components, including ending balances and the year's activity. Currently, OMB requires federal

[3]U.S. Department of the Treasury, *Consolidated Financial Report Improvement Project: Recommendations to the Consolidation Process* (Washington D.C.: Nov. 15, 2001).

agencies to identify intragovernmental assets and liabilities on their audited balance sheets but does not require the intragovernmental portion of net position to be identified. Without a process in place to identify and quantify all components of the activity in the net position line item, revenues, costs, assets, and liabilities may be misstated, thereby affecting the reliability of the CFS.

As Treasury is designing its new financial statement compilation process to begin with the fiscal year 2004 CFS, we recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management, to

- develop reconciliation procedures which will aid in understanding and controlling the net position balance as well as eliminate the plugs previously associated with compiling the CFS; and

- use balanced accounting entries to account for the change in net position rather than simple subtraction of liabilities from assets.

Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to fully reconcile intragovernmental activity and balances. OMB and Treasury require CFO Act agencies to reconcile selected intragovernmental activity and balances with their "trading partners"[4] and 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 us. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for fiscal year 2002, citing reasons such as (1) failure of trading partners to provide needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resource issues. For fiscal year 2002, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. A lack of standardization in transaction processing and a lack of sufficient communication between trading partners contribute significantly to federal agencies' inability to fully reconcile intragovernmental activity and balances. Without improvement in this area, Treasury cannot properly eliminate intragovernmental activity

[4]Trading partners are U.S. government agencies, departments, or other components included in the CFS that do business with each other.

and balances and, as a result, assets, liabilities, revenue, and costs reported in the CFS may not be fairly stated.

Federal agencies are required to consistently and fully account for, reconcile, and report intragovernmental activity and balances across the federal government. To address certain issues that have contributed to the out-of-balance condition for intragovernmental activity and balances, OMB has established a set of standard business rules, OMB Memorandum M-03-01, *Business Rules for Intragovernmental Transactions*, for governmentwide transactions among trading partners; the memorandum requires quarterly reconciliations of intragovernmental activity and balances, beginning with fiscal year 2003. *Treasury Financial Manual*, section 4030, also requires reconciliation of intragovernmental activity and balances. Further, Treasury has begun a process to help federal agencies better perform their reconciliations, by providing each agency with detailed trading partner information. Also, Treasury is planning to require federal agencies, beginning with fiscal year 2004, to report in Treasury's new closing package intragovernmental activity and balances by trading partner.

As OMB continues to make strides to address issues related to intragovernmental transactions, we recommend that the Director of the Office of Management and Budget direct the Controller of the Office of Federal Financial Management to

- develop policies and procedures that document how OMB will enforce the business rules provided in OMB Memorandum M-03-01, *Business Rules for Intragovernmental Transactions*, and

- require that significant differences noted between business partners be resolved and the resolution be documented.

We also recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of the Office of Management and Budget, to implement the plan to require federal agencies to report in Treasury's new closing package, beginning with fiscal year 2004, intragovernmental activity and balances by trading partner and indicate amounts that have not been reconciled with trading partners and amounts, if any, that are in dispute.

Elimination of Intragovernmental Activity and Balances

During our audits, we found the following:

- Intragovernmental activity and balances are "dropped" or "offset" in the preparation of the CFS rather than eliminated through balanced accounting entries.

- Certain intragovernmental activity and balances, primarily related to appropriations, are not being properly considered in the consolidation process.

- No reconciliation is performed for the change in intragovernmental assets and liabilities for the fiscal year, including the amount and nature of all changes in intragovernmental assets or liabilities not attributable to cost and revenue activity recognized during the fiscal year, such as differences due to purchases that are capitalized as inventory or equipment and revenue that is deferred.

Consolidated financial statements are intended to present the results of operations and financial position of the components that make up the reporting entity as if the entity were a single enterprise. Therefore, when preparing the CFS, intragovernmental activity and balances between federal agencies must be eliminated. As mentioned above, federal agencies' problems in handling their intragovernmental transactions impair Treasury's ability to properly eliminate these transactions, and significant differences in intragovernmental accounts have been identified. Without an effective process, intragovernmental activity and balances are not fully accounted for and eliminated in the process used to prepare the CFS. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the CFS is impaired and, consequently, the CFS may be misstated.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with OMB's Controller of the Office of Federal Financial Management, to

- design procedures that will account for the difference in intragovernmental assets and liabilities throughout the compilation process by means of formal consolidating and elimination accounting entries;

- develop solutions for intragovernmental activity and balance issues relating to federal agencies' accounting, reconciling, and reporting in areas other than those OMB now requires be reconciled, primarily areas relating to appropriations; and

- reconcile the change in intragovernmental assets and liabilities for the fiscal year, including the amount and nature of all changes in intragovernmental assets or liabilities not attributable to cost and revenue activity recognized during the fiscal year. Examples of these differences would include capitalized purchases such as inventory or equipment and deferred revenue.

Reconciliation of Net Operating Cost and Unified Budget Surplus (or Deficit)

Treasury did not have an adequate process to identify and report items needed to reconcile the U.S. government's fiscal year 2002 net operating cost of $364.9 billion to the fiscal year 2002 unified budget deficit, which was reported as $157.7 billion. The Reconciliation of Net Operating Cost and Unified Budget Surplus (or Deficit) (hereafter referred to as the reconciliation statement) is expected to explain certain differences that occur because the CFS are prepared on the accrual basis in accordance with U.S. generally accepted accounting principles. Under accrual accounting, transactions are reported when the event or transaction is recognizable under U.S. generally accepted accounting principles rather than when cash is received and paid. By contrast, federal budgetary reporting is, with certain exceptions, on the cash basis, in accordance with accepted budget concepts and policies. Statement of Federal Financial Accounting Standards (SFFAS) No. 24, *Selected Standards for the Consolidated Financial Report of the United States Government*, effective in fiscal year 2002, requires the reconciliation statement as part of the CFS.

In our audit of the reconciliation statement, we found that Treasury was unable to identify all the transactions needed to properly reconcile the statement. Treasury's process for compiling the reconciliation statement involved the use of two independent sources of information—FACTS data from federal agencies' general ledger systems for the net operating cost and most of the reconciliation statement items and Treasury's central accounting and reporting system (STAR) primarily for the unified budget surplus/deficit amounts. The reconciliation statement begins with the net operating cost amount reported in the Statement of Operations and Changes in Net Position (derived through FACTS data). As noted above, this amount includes a net $17.1 billion labeled as "unreconciled transactions," which was needed to balance the consolidated Balance

Sheet. Because the net operating cost amount includes this plug, which does not correspond to any budget activity, the $17.1 billion should have been included as a reconciling item in the reconciliation statement, but it was not. In addition, a $1 billion "net amount of all other differences" (another plug) was also needed in the reconciliation statement to balance net operating cost to the unified budget deficit. Treasury was unable to adequately identify and explain the gross components of such amounts.

Treasury's process for preparing the reconciliation statement also did not ensure completeness of reporting or ascertain the consistency of all the amounts reported in the reconciliation statement with the related balance sheet line items, related notes, or federal agency financial statements. We performed an analysis to determine whether all applicable components reported in the other statements (and related note disclosures) included in the CFS were properly reflected in the reconciliation statement. We found about $21 billion of net changes in various line item account balances on the balance sheet that were not explained on either the reconciliation statement or the Statement of Changes in Cash Balance from Unified Budget Surplus and Other Activities. For example, the reconciliation statement reported depreciation expense ($20.5 billion) and total capitalized fixed assets ($40.9 billion) as the components of the net change in property, plant, and equipment. Although these activities accounted for a net increase of $20.4 billion, the balance sheet reflected a smaller net increase, $18 billion; Treasury was unable to explain the remaining $2.4 billion of the net change. In addition, while we found that the source of the line item "principal repayments of precredit reform loans" that is reported on the reconciliation statement was from STAR, Treasury was unable to link this amount of $8.2 billion to any related agency financial statements or the consolidated Balance Sheet and related notes.

Lastly, Treasury did not establish a reporting materiality threshold for purposes of collecting and reporting information in the reconciliation statement. For example, some items were reported simply as a net "increase/decrease" without considering how material, both quantitatively and qualitatively, the gross changes were.[5] We noted, for instance, that in the "components of the budget surplus (deficit) not part of net operation cost" section of the statement, there is a reconciling item titled "increase in

[5]An item's omission or error is considered material if the surrounding circumstances make it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

inventory" rather than accounting for "purchases of inventory" as a "component of the budget surplus (deficit) not part of net operation cost" and separately reporting the "sales, use, or disposal of inventory" in the "components of net operating cost not part of the budget surplus (or deficit)." Treasury was unable to demonstrate whether material, informative amounts were netted, and pertinent information may therefore not be disclosed.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary to develop and implement a process that adequately identifies and reports items needed to reconcile its net operating cost and unified budget surplus (or deficit). Treasury should

- report "net unreconciled differences" included in the net operating results line item as a separate reconciling activity in the reconciliation statement,

- develop policies and procedures to ensure completeness of reporting and document how all the applicable components reported in the other consolidated financial statements (and related note disclosures included in the CFS) were properly reflected in the reconciliation statement, and

- establish reporting materiality thresholds for determining which agency financial statement activities to collect and report at the governmentwide level to assist in ensuring that the reconciliation statement is useful and conveys meaningful information.

In addition, if Treasury chooses to continue using information both from federal agencies' financial statements and from the STAR system, we recommend that Treasury

- demonstrate how the amounts from STAR reconcile to federal agencies' financial statements and

- identify and document the cause, if any significant differences are noted.

Statements of Changes in Cash Balance from Unified Budget and Other Activities

Treasury was unable to demonstrate how significant amounts reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities were related to the underlying federal agencies' financial statements. The Statement of Changes in Cash Balance from Unified Budget and Other Activities is expected to explain how the annual unified budget surplus or deficit relates to the change in the U.S. government's operating cash. SFFAS No. 24, effective in fiscal year 2002, requires the Statement of Changes in Cash Balance from Unified Budget and Other Activities as part of the CFS.

For fiscal year 2002, the Statement of Changes in Cash Balance from Unified Budget and Other Activities reported a unified budget deficit of $157.7 billion, derived as the difference between reported actual unified budget receipts of $1,853.3 billion and actual unified budget outlays of $2,011 billion. Both line items were material to this statement and were compiled from federal agencies' monthly reports to Treasury in the STAR system.

Treasury was unable to explain material differences, totaling $231 billion (absolute) and $166 billion (net), between the actual unified budget net outlays reported on this statement and the outlays reported on selected individual federal agencies' audited Combined Statement of Budgetary Resources. For example, we found one federal agency that reported net outlays for fiscal year 2002 as $479 billion on its audited Combined Statement of Budgetary Resources, while Treasury's records showed $375 billion for fiscal year 2002 for this agency. This agency had received an unqualified auditor opinion on its financial statements.

OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*,[6] states that outlays in federal agencies' Combined Statement of Budgetary Resources should agree with the net outlays reported in the budget of the U.S. government. In addition, SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including outlays) and the amounts described as "actual" in the budget of the U.S. government.

[6]Office of Management and Budget, *Form and Content of Agency Financial Statements*, OMB-01-09 (Washington, D.C.: Sept. 25, 2001). This bulletin is OMB's official guidance for the form and content of federal agencies' financial statements.

Treasury believes its records for net outlays are reliable and accurate; however, many federal agencies are reporting different net outlays and receiving clean opinions on their financial statements.

Treasury was unable to adequately explain the over $24 billion net difference between actual unified budget receipts of $1,853.3 billion and total operating revenue of $1,877.7 billion reported in the Statements of Operations and Changes in Net Position. While these amounts are not expected to equal (for example, operating revenues include accrued amounts, and budget receipts are reported on the cash basis), there is a relationship between operating revenues reported on the Statement of Operations and Changes in Net Position and unified budget receipts reported on the Statement of Changes in Cash Balance from Unified Budget and Other Activities. Therefore, the expectation is that differences between these amounts should be explainable.

Treasury was also not able to provide support for how the line items in the "other activities" section of this statement, totaling $13.5 billion, related to either the underlying Balance Sheet or related notes accompanying the CFS.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management, to develop and implement a process to ensure that the Statement of Changes in Cash Balance from Unified Budget and Other Activities properly reflects the activities reported in federal agencies' audited financial statements. Treasury should

- document the consistency of the significant line items on this statement to agencies' audited financial statements;

- request, through its closing package, that federal agencies provide the net outlays reported in their Combined Statement of Budgetary Resources and explanations for any significant differences between net outlay amounts reported in the Combined Statement of Budgetary Resources and the budget of the U.S. government;

- investigate the differences between net outlays reported in federal agencies' Combined Statement of Budgetary Resources and Treasury's records in the STAR system to ensure that the proper amounts are reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities;

- explain and document the differences between the operating revenue amount reported on the Statement of Operations and Changes in Net Position and unified budget receipts reported on the Statement of Changes in Cash Balance from Unified Budget and Other Activities; and

- provide support for how the line items in the "other activities" section of this statement relate to either the underlying Balance Sheet or related notes accompanying the CFS.

Defining the Reporting Entity

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

Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, *Entity and Display*, provides guidance on defining reporting entities. Under SFFAC No. 2, a reporting entity for general purpose financial statements would "meet all of the following criteria: (1) there is a management responsible for controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof . . ., and held accountable for the entity's performance; (2) the entity's scope is such that its financial statements would provide a meaningful representation of operations and financial condition; and (3) there are likely to be users of the financial statements who are interested in and could use the information in the statements to help them make resource allocation and other decisions and hold the entity accountable for its deployment and use of resources." SFFAC No. 2 also calls for the notes to financial statements to provide disclosures that are necessary to make the financial statements more informative and not misleading, such as a brief description of the reporting entity. The statement also provides criteria for including components in a reporting entity. As examples of the application of such criteria, SFFAC No. 2 specifically discusses the Federal Reserve System and government-sponsored enterprises and the reasons for FASAB's conclusion that these entities would not be considered components of the U.S. government reporting entity.

In accordance with SFFAC No. 2, if the government could provide evidence that the financial information not included in the CFS is immaterial,[7] then the CFS reporting entity could be described as the "U.S. government" and would conform materially to the criteria set forth in SFFAC No. 2. However, the fiscal year 2002 CFS reporting entity excluded certain entities without providing evidence or clearly explaining the reason.

An appendix to the CFS listed 13 entities that were excluded from the CFS reporting entity and specifically explained the reason for excluding one of those entities—the Federal Reserve System. However, the appendix did not explain the reason for excluding the other entities listed as excluded, such as government-sponsored enterprises and military exchanges. While exclusion of those entities may be appropriate, some users of the CFS may be confused if the reason for excluding entities is not clearly disclosed in the CFS.

We understand the inherent challenges in getting complete information for all three branches of the U.S. government. However, not including required information for all components included in a reporting entity or not clearly explaining the reason for excluding certain entities could mislead some users of the financial statements.

Without evidence of the amounts of information excluded and any related disclosures, in particular, evidence that what was excluded was immaterial to the CFS, we could not have ample assurance regarding the unknown amounts, and, under auditing standards, this issue could impede a future opinion on the CFS.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management to do the following:

- Perform an assessment to define the reporting entity, including its specific components, in conformity with the criteria issued by FASAB. Key decisions made in this assessment should be documented, including

[7]To assess the materiality of any issue, the indicative criteria discussed in SFFAC No. 2 state that (1) the materiality of the entities and their relationship with one another should be considered, (2) materiality should not be measured solely in dollars, and (3) potential embarrassment to any of the entities' stakeholders should also be considered. Thus, a bias toward expansiveness and comprehensiveness would be justified, particularly if it could contribute to maintenance of fiscal control.

the reason for including or excluding components and the basis for concluding on any issue. Particular emphasis should be placed on demonstrating that any financial information that should be included, but is not included, is immaterial.

- Provide in the financial statements all the financial information relevant to the defined reporting entity, in all material respects. Such information would include, for example, the reporting entity's assets, liabilities, and revenues.

- Disclose in the financial statements all information that is necessary to inform users adequately about the reporting entity. Such disclosures should clearly describe the reporting entity and explain the reason for excluding any components that are not included in the defined reporting entity.

Conformity with U.S. Generally Accepted Accounting Principles

Treasury lacks an adequate process to ensure that the financial statements, related notes, stewardship, and supplemental information in the CFS are presented in conformity with U.S. generally accepted accounting principles. SFFAS No. 24 states that FASAB standards apply to all federal agencies, including the U.S. government as a whole, unless provision is made for different accounting treatment in a current or subsequent standard.

Specifically, we found that Treasury did not (1) timely identify applicable generally accepted accounting principles requirements, (2) make timely modifications to agency data calls to obtain information needed, (3) assess, qualitatively and quantitatively, the materiality of omitted disclosures,[8] or (4) document decisions reached with regard to omitted disclosures and the rationale for such decisions. We identified numerous disclosures that were not in conformity with applicable standards. These needed disclosures are described in appendix I. We did note that Treasury is requesting certain information in its planned closing package for fiscal year 2004 that may address some of the needed disclosures.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary to establish a formal process that will allow the

[8]See footnote 5.

financial statements, related notes, stewardship, and supplemental information in the CFS to be presented in conformity with U.S. generally accepted accounting principles. The process should

- timely identify generally accepted accounting principles requirements,
- make timely modifications to Treasury's closing package requirements to obtain information needed,
- assess, qualitatively and quantitatively, the impact of the omitted disclosures, and
- document decisions reached and the rationale for such decisions.

With respect to the 16 required disclosures identified in appendix I that were not included in the CFS, we recommend that each of these disclosures be included in the CFS or the rationale for excluding any of them be documented.

Other Weaknesses Identified

During our audit we found certain issues related to (1) management representation letters, (2) legal representation letters, and (3) information on major treaties and other international agreements that will require certain actions by Treasury and OMB. Other issues related to these same three areas will need to be addressed by federal agencies and their auditors to facilitate Treasury's and OMB's preparation of the CFS. We plan to separately communicate to agency Chief Financial Officers and Inspectors General the details of our concerns for such issues. We have summarized our findings below and are providing recommendations to help address the issues that require action by Treasury and OMB.

Management Representation Letters and the Related Summaries of Unadjusted Misstatements

For each agency financial statement audit, generally accepted auditing standards require that agency auditors obtain written representations from agency management as part of the audit. In turn, Treasury and OMB are to receive all the required management representation letters and the related summaries of unadjusted misstatements from the federal agencies. This is important because generally accepted auditing standards require Treasury and OMB to provide us, as their auditor, a management representation letter for the CFS, and their letter depends on the information within agencies' management representation letters. However, we found that

Treasury and OMB did not have policies or procedures to adequately review and analyze federal agencies' management representation letters.

In a management representation letter, management typically acknowledges its responsibility for its financial statements and its belief that the financial statements are presented in conformity with U.S. generally accepted accounting principles; the completeness of financial information in the statements; recognition, measurement, and disclosure; and subsequent events. Without performing an adequate review and analysis of federal agencies' management representations letters, Treasury and OMB management may not be fully informed of matters that may affect their representations made with respect to the audit of the CFS.

As part of our audit of the CFS, we received and reviewed 30 federal agencies' management representation letters.[9] We found that (1) 2 letters had discrepancies between what the auditor found and what the agency represented in its management representation letter, (2) 8 letters were not signed by the appropriate level of management, (3) 25 letters did not disclose the materiality threshold used by management in determining items to be included in the letter, (4) 4 letters omitted certain representations that are ordinarily included, (5) 2 letters did not include a schedule of unadjusted misstatements or affirm in their representation letter that there were no uncorrected misstatements, and (6) 15 schedules of unadjusted misstatements did not provide complete information about the misstatements that were identified. Only 1 of the 30 letters we reviewed had none of the deficiencies noted above.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management, to establish written policies and procedures for preparing the governmentwide management representation letter to help ensure that it is properly prepared and contains sufficient representations. Specifically, these policies and procedures should require

- an analysis of the agency management representations to determine if discrepancies exist between what the agency auditor reported and the representations made by the agency, including the resolution of such discrepancies;

[9]We requested 24 federal agency management representation letters. We received an additional 6 letters that we also included in our review.

- a determination that the agency management representation letters have been signed by the highest-level agency officials that are responsible for and knowledgeable about the matters included in the agency management representation letters;
- an assessment of the materiality thresholds used by federal agencies in their respective management representation letters;
- an assessment of the impact, if any, of federal agencies' materiality thresholds on the management representations made at the governmentwide level;
- an evaluation and assessment of the omission of representations ordinarily included in agency management representation letters; and
- an analysis and aggregation of the agencies' summary of unadjusted misstatements to determine the completeness of the summaries and to ascertain the materiality, both individually and in the aggregate, of such unadjusted misstatements to the CFS taken as a whole.

Legal Representation Letters and Related Management Schedules in Reporting Contingency Losses

For each agency financial statement audit, generally accepted auditing standards require that agency auditors obtain written legal representations as part of the audit. Legal representation letters, along with related management schedules,[10] are essential to properly reporting legal contingency losses in federal agencies' financial statements. Inadequate information in the legal representation letters could weaken the accuracy and reliability of federal agency financial statements and the CFS.

We reviewed 34 federal agencies' legal representations letters and related management schedules to assess the adequacy of the letters and related schedules.[11] We found that the adequacy of some legal letters was questionable. For example, we found that 2 letters did not express an opinion of how the expected outcome of virtually all of the two agencies'

[10]Office of Management and Budget, *Audit Requirements for Federal Financial Statements*, OMB-01-02 (Washington, D.C.: Oct. 16, 2000), requires agency chief financial officers to prepare a management schedule that documents how the information obtained in the legal counsel's response was considered in preparing the financial statements.

[11]We requested 24 federal agency legal representation letters. We received an additional 10 letters that we also included in our review.

cases would be resolved, and that 5 agencies did not provide the related management schedules.

In some cases, the lack of adequate information may have resulted from legal counsel's desire to protect the confidentiality of lawyer-client communications, the difficulty in predicting the outcome of potential and pending litigation with any assurance, and/or legal counsel's desire to avoid the possibility of prejudicing the outcome of the litigation to the client's detriment. While these are understandable reasons, without adequate legal contingency information, management of Treasury and OMB may not be fully informed of matters that may affect the legal representations made with respect to the audit of the CFS.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management, to help ensure that agencies provide

- adequate information in their legal representation letters regarding the expected outcome of the cases and
- related management schedules.

Information on Major Treaties and Other International Agreements

The CFS note disclosures did not include any information on major treaties and other international agreements[12] to which the federal government is a party. These treaties and other international agreements address various issues including, but not limited to, trade, commerce, security, and arms that may involve financial obligations or give rise to loss contingencies.

Treaties and other international agreements may lead to commitments or contingencies and therefore should be included in the CFS, in accordance with OMB Bulletin No. 01-09 and SFFAS No. 5, *Accounting for Liabilities*

[12]The term treaty in its technical usage in the United States denotes international agreements made by the President with the advice and consent of the Senate in accordance with Article II, section 2, of the Constitution of the United States. In addition to such treaties, authorized representatives of the federal government may, pursuant to existing law or treaties, enter into other international agreements that are governed by international law. The entering into and record keeping of such international agreements by federal agencies are governed by the Case-Zablocki Act, 1 U.S.C. section 112b, and implementing State Department regulations, 22 C.F.R. Part 181 (2002).

of the Federal Government, as amended by SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation.* The degree of certainty as to whether there will be a cost now or in the future, along with the ability to quantify it in advance, determines the appropriate accounting treatment.

Treaties and other international agreements were not included in the notes to the CFS because Treasury and the federal agencies had yet to perform the necessary work to determine the nature and magnitude of those in force as of September 30, 2002. The State Department publishes a document annually called *Treaties in Force*. The most recent edition of *Treaties in Force*, released in August 2002, lists treaties and other international agreements of the United States that were in force on January 1, 2002. However, according to State Department staff, this document is incomplete because federal agencies do not always provide complete information on treaties and international agreements when a request for data is made. Not having information on major treaties and other international agreements in the CFS resulted in incomplete disclosures of the possible exposure to loss or obligations of the U.S. government.

We recommend that the Secretary of the Treasury direct the Fiscal Assistant Secretary, working in coordination with the Controller of OMB's Office of Federal Financial Management, to establish written policies and procedures to help ensure that major treaty and other international agreement information is properly identified and reported in the CFS. Specifically, these policies and procedures should require that agencies

- develop a detailed schedule of all major treaties and other international agreements that obligate the U.S. government to provide cash, goods, or services, or that create other financial arrangements that are contingent on the occurrence or nonoccurrence of future events (a starting point for compiling these data could be the State Department's *Treaties in Force*);

- classify all such scheduled major treaties and other international agreements as commitments or contingencies;

- disclose in the notes to the CFS amounts for major treaties and other international agreements that have a reasonably possible chance of resulting in a loss or claim as a contingency;

- disclose in the notes to the CFS amounts for major treaties and other international agreements that are classified as commitments and that may require measurable future financial obligations; and

- take steps to prevent major treaties and other international agreements that are classified as remote from being recorded or disclosed as probable or reasonably possible in the CFS.

Agency Comments and Our Evaluation

In written comments on a draft of this report, which are reprinted in appendix II, Treasury and OMB stated that our report identified many recommendations that will improve the usefulness and accuracy of the CFS and that they have already incorporated many of them into their new system and processes that are being developed for preparing the fiscal year 2004 CFS. However, Treasury and OMB disagreed with our recommendations related to unreconciled transactions affecting net position and the Statement of Changes in Cash Balance from Unified Budget and Other Activities. They also stated that they would consider the other recommendations in our report as they continue the design and implementation of the new process for preparing the CFS.

On the first matter, Treasury and OMB disagreed with our proposed recommendation that federal agencies submit to Treasury an analysis of their net position that separates intragovernmental and public transactions. The purpose of this recommendation was to help Treasury understand and control the U.S. government's net position, as well as to eliminate the plugs associated with compiling the CFS. In response to our draft report, Treasury and OMB stated that Treasury had decided not to require agencies to split net position between intragovernmental and public transactions as Treasury had originally planned and reported in its CFS Improvement Project Report because it was unable to develop a procedure that agencies could use to provide this split. In addition, Treasury and OMB stated that this split would not identify certain items known to affect the unreconciled net position transactions. However, because Treasury has not identified and quantified all the components of the unreconciled transactions, a procedure is still needed that will adequately reconcile net position and assist Treasury in identifying and eliminating the plugs needed to balance the CFS. Our proposed recommendation in the draft report that we provided for comment was one option for Treasury to resolve the uncertainties regarding the reliability of these data. We recognize there are other ways to gain these assurances. Therefore, we have modified our recommendation to recommend that Treasury develop reconciliation

procedures to aid in understanding and controlling the net position balance.

Regarding the second matter, Treasury and OMB stated that we had suggested that federal agency data be used to prepare receipts and outlays used in the Statement of Changes in Cash Balance from Unified Budget and Other Activities. They stated that they disagree with this approach because it would be time-consuming and costly to gather such information. Treasury and OMB have stated that the Statement of Changes in Cash Balance from Unified Budget and Other Activities is prepared from information derived from Treasury's Central Accounting System rather than from agencies' financial statements.

We were not calling for Treasury to use federal agencies' financial statements to prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities. Instead, we recommended that Treasury collect certain information already reported in federal agencies' audited financial statements and develop procedures that ensure consistency of the significant line items on the Statement of Changes in Cash Balance from Unified Budget and Other Activities with the agency-reported information. As we stated in our report, Treasury has expressed the belief that the information it maintains in its system is materially reliable. However, federal agencies also believe their amounts are materially reliable and their auditors have rendered unqualified audit opinions on their financial statements. We found unexplained material differences between Treasury's records and some agencies' financial statements. We provided a schedule of these differences to Treasury and requested explanations for the material differences. As discussed in our report, Treasury was unable to explain material differences, totaling $231 billion (absolute) and $166 billion (net), between the actual unified budget net outlays reported on this statement and the net outlays reported on selected individual federal agencies' audited Combined Statement of Budgetary Resources.

As stated in our report, OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, states that outlays in federal agencies' Combined Statement of Budgetary Resources should agree with the net outlays reported in the budget of the U.S. government. In some cases, we found that net outlay amounts reported in federal agencies' audited financial statements differed from the amounts included in the CFS and budget of the U.S. government for these agencies. For example, Treasury did not provide us with an explanation of why its own audited Combined

Statement of Budgetary Resources reported net outlays of $479 billion for fiscal year 2002, while the amount included in the CFS relating to net outlays for the Department of Treasury was only $375 billion for fiscal year 2002.

Ensuring that the significant line items on the Statement of Changes in Cash Balance from Unified Budget and Other Activities are consistent with agencies' audited financial statements is an important expectation. As stated in our report, SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires agencies to provide an explanation for any material differences between the information required to be disclosed (including outlays) in their financial statements and the amounts described as "actual" in the budget of the U.S. government. Also, many of the amounts reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities are intended to be the same as the amounts reported in the budget of the U.S. government. As such, we continue to believe that the process we proposed would be the most efficient manner for Treasury, as the preparer of the CFS, to obtain the necessary assurance on the significant amounts reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities.

Treasury and OMB also suggested that we not address the recommendations in our report related to management representation letter and legal representation letter issues to Treasury. Generally accepted auditing standards require Treasury and OMB to provide us, as their auditor, a management representation letter for the CFS, and their letter depends on the information within agencies' management representation letters. However, we found that Treasury and OMB did not have policies or procedures to adequately review and analyze federal agencies' management representation letters. As such, we continue to believe that both Treasury and OMB need to work together to address the recommendations we made in this area.

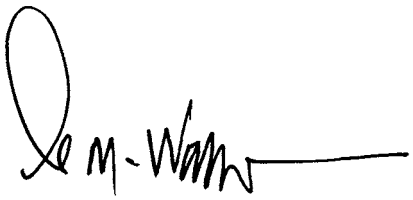
In regard to legal representation letters, we identified problems with certain agencies' letters that could weaken the accuracy and reliability of federal agencies' financial statements and the CFS. OMB, in its role of providing guidance to agencies and their auditors regarding agencywide financial statements, and Treasury, in its role as preparer of the CFS, both play an important part in ensuring that legal representation letters provide adequate information to enable the proper reporting of legal contingency losses in federal financial statements. As such, we continue to believe that

both Treasury and OMB need to work together to address the recommendations we made in this area as well.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should submit your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform within 60 days of the date of this letter. A written statement must also be sent to the House and Senate Committees on Appropriations with the agencies' first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs; the Subcommittee on Financial Management, the Budget, and International Security, Senate Committee on Governmental Affairs; the House Committee on Government Reform; and the Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform. In addition, we are sending copies to the Fiscal Assistant Secretary of the Treasury and OMB's Controller of the Office of Federal Financial Management. Copies will be made available to others upon request. This report is also available at no charge on GAO's Web site, at www.gao.gov.

We acknowledge and appreciate the cooperation and assistance provided by Treasury and OMB during our audit. If you or your staff have any questions or wish to discuss this report, please contact Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, on (202) 512-2600 or Gary T. Engel, Director, Financial Management and Assurance, on (202) 512-3406.



David M. Walker
Comptroller General
of the United States

Disclosure Issues

This enclosure includes 16 disclosures identified that are required by U.S. generally accepted accounting principles to either be included in the CFS or the rationale for their exclusion documented. However, they were neither included nor was their exclusion documented.

Loans Receivable and Loan Guarantee Liabilities

The note disclosure for loans receivable and loan guarantee liabilities departed from the following disclosure requirements of Statements of Federal Financial Accounting Standards (SFFAS) No. 3, *Accounting for Inventory and Related Property,* and SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees.*

SFFAS No. 3, paragraph 91, requires the reporting entity to disclose the following:

- valuation basis for foreclosed property;
- changes from the prior year's accounting methods, if any;
- restrictions on the use/disposal of property;
- balances by categories (i.e., pre-1992 and post-1991 foreclosed property);
- number of properties held and average holding period by type or category; and
- number of properties for which foreclosure proceedings are in process at the end of the period for foreclosed assets acquired in full or partial settlement of a direct or guaranteed loan.

SFFAS No. 18, paragraph 9, states that credit programs should reestimate the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees. There are two kinds of reestimates: (a) interest rate reestimates and (b) technical/default reestimates. Entities should measure and disclose each program's reestimates in these two components separately.

SFFAS No. 18, paragraph 10, requires the reporting entity to display in the notes to the financial statements a reconciliation between the beginning and ending balances of the subsidy cost allowance for outstanding direct

loans and the liability for outstanding loan guarantees reported in the entity's balance sheet.

SFFAS No. 18, paragraph 11, requires disclosure of

- the total amount of direct or guaranteed loans disbursed for the current reporting year and the preceding reporting year;
- the subsidy expense by components, recognized for the direct or guaranteed loans disbursed in those years; and
- the subsidy reestimates by components for those years.

SFFAS No. 18, paragraph 11, also requires disclosure, at the program level, of the subsidy rates for the total subsidy cost and its components for the interest subsidy costs, default costs (net of recoveries), fees and other collections, and other costs estimated for direct loans and loan guarantees in the current year's budget for the current year's cohorts.

SFFAS No. 18, paragraph 11, further requires the reporting entity to disclose, discuss, and explain events and changes in economic conditions, other risk factors, legislation, credit policies, and subsidy estimation methodologies and assumptions that have had a significant and measurable effect on subsidy rates, subsidy expense, and subsidy reestimates.

Inventories and Related Property

The note disclosure for inventories and related property departed from the following disclosure requirements of SFFAS No. 3, *Accounting for Inventory and Related Property.*

Inventory and Operating Materials and Supplies

When inventory or operating materials and supplies are declared excess, obsolete, or unserviceable, SFFAS No. 3, paragraph 30, requires the difference between the carrying amount and the expected net realizable value to be recognized as a loss or gain and either separately reported or disclosed.

Paragraphs 35 and 50 require the following disclosures about inventory and operating materials and supplies:

- general composition;

- changes from the prior year's accounting methods, if any;
- restrictions on the sale of inventory and the use of operating materials and supplies; and
- changes in the criteria for categorizing inventory and operating materials and supplies.

Stockpile Material

Paragraph 56 requires the following disclosures about stockpile material:

- basis for valuing stockpile material, including valuation method and any cost flow assumptions;
- changes from the prior year's accounting methods, if any;
- restrictions on the use of stockpile material;
- balances in each category of stockpile material (i.e., stockpile material held and held for sale);
- criteria for grouping stockpile material held for sale; and
- changes in criteria for categorizing stockpile material held for sale.

Paragraph 55 requires the disclosure of any difference between the carrying amount (i.e., purchase price or cost) of stockpile material held for sale and the estimated selling price of such assets.

Seized Material

Paragraph 66 requires the following disclosures about seized property:

- valuation method;
- changes from the prior year's accounting methods, if any; and
- analysis of change in seized property (including dollar value and number of seized properties) that are on hand at the beginning of the year, seized during the year, disposed of during the year, and on hand at the end of the year, as well as known liens or other claims against the property. This information should be presented by type of seizure and method of disposition when material.

Forfeited Property

Paragraph 78 requires the following disclosures about forfeited property:

- valuation method;
- analysis of the changes in forfeited property by type and dollar amount that includes (1) number of forfeitures on hand at the beginning of the year, (2) additions, (3) disposals and method of disposition, and (4) end-of-year balances;
- restriction on the use of disposition of the property; and
- if available, an estimate of the value of property to be distributed to other federal, state, and local agencies in future reporting periods.

Goods Held under Price Support and Stabilization Programs

Paragraph 98 requires that if a contingent loss is not recognized because it is less than probable or it is not reasonably measurable, then disclosure of the contingency shall be made if it is at least reasonably possible that a loss may occur.

Paragraph 109 requires the following disclosures for goods held under price support and stabilization programs:

- basis for valuing commodities, including valuation method and cost flow assumptions;
- changes from the prior year's accounting methods;
- restrictions on the use, disposal, or sale of commodities; and
- analysis of the change in dollar amount and volume of commodities, including those (1) on hand at the beginning of the year, (2) acquired during the year, (3) disposed of during the year by method of disposition, (4) on hand at the end of the year, (5) on hand at year-end and estimated to be donated or transferred during the coming period, and (6) received as a result of surrender of collateral related to nonrecourse loans outstanding. The analysis should also show the dollar value and volume of purchase agreement commitments.

Property, Plant, and Equipment

The note disclosure for property, plant, and equipment (PP&E) departed from the following disclosure requirements of SFFAS No. 6, *Accounting for Property, Plant, and Equipment;* SFFAS No. 10, *Accounting for Internal Use Software;* and SFFAS No. 16, *Amendments to Accounting for Property, Plant, and Equipment:*

SFFAS No. 6, paragraph 45, states that the following disclosures should be included:

- the estimated useful lives for each major class;
- capitalization thresholds, including any changes in thresholds during the period; and
- restrictions on the use or convertibility of general PP&E.

SFFAS No. 10, paragraph 35, requires the following disclosures for internal use software:

- the cost, associated amortization, and book value;
- the estimated useful life for each major class of software; and
- the method of amortization.

SFFAS No. 16, paragraph 9, requires an appropriate PP&E note disclosure to explain that "physical quantity" information for the multiuse heritage assets is included in supplemental stewardship reporting for heritage assets.

Federal Employee and Veteran Benefits Payable

The note disclosure for federal employee and veteran benefits payable was not complete and properly reported because the liability for military pensions and the note disclosure related to the "change in actuarial accrued pension liability and components of related expenses" for the military retirement fund do not agree with information presented in the Department of Defense's (DOD) financial statements. The note disclosure included in the CFS does not include a line for the valuation of plan amendments that occurred during the year. DOD correctly reported plan amendments separately in its financial statements; however, the

mechanism was not available through FACTS submission for DOD to report plan amendments separately to the Department of the Treasury.

Environmental and Disposal Liabilities

The note disclosure for environmental and disposal liabilities departed from the requirements of SFFAS No. 6 in two instances. The note disclosure on environmental liabilities was not complete and properly reported primarily because DOD was unable to fully implement elements of U.S. generally accepted accounting principles and OMB guidance. Specifically, the disclosures should do the following:

- Estimate and recognize cleanup costs associated with general PP&E at the time the PP&E is placed in service. In addition, a liability should be recognized for the portion of the estimated total cleanup cost that is attributable to that portion of the physical capacity used or that portion of the estimated useful life that has passed since the general PP&E was placed in service. As Treasury indicated in its note disclosures, DOD was unable to fully implement these two elements of U.S. generally accepted accounting principles. However, the note disclosure did not explain how these limitations prevented DOD from properly estimating its environmental liability. Linking the environmental liability to weaknesses in the DOD property, plant, and equipment systems would have made the CFS more useful to the reader.

- Include material changes in total estimated cleanup costs due to changes in laws, technology, or plans. When preparing the CFS, Treasury should consider whether the reader would be interested in understanding why the liability changed and include the explanation in the note disclosure.

Other Liabilities

The note disclosure for other liabilities departed from the following disclosure requirements for capital leases and life insurance liabilities:

Capital Leases

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases*, paragraph 16, requires the following disclosures on capital leases:

- future minimum lease payments as of the date of the latest balance sheet presented, in the aggregate and for each of the 5 succeeding fiscal

years, with separate deductions from the total for the amount representing executory costs, including any profit thereon, included in the minimum lease payments, and for the amount of the imputed interest necessary to reduce the net minimum lease payments to present value;

- a summary of assets under capital lease by major asset category and the related total accumulated amortization; and

- a general description of the lessee's leasing arrangements, including but not limited to (1) the basis on which contingent rental payments are determined, (2) the existence and terms of renewal or purchase options and escalation clauses, and (3) restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

Life Insurance Liabilities

The note disclosure for other liabilities departed from the following disclosure requirements of SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, with respect to life insurance liabilities:

- Paragraph 117 states that all federal reporting entities with whole life insurance programs should follow the standards as prescribed in the private sector standards when reporting the liability for future policy benefits. The applicable private sector standards are SFAS No. 60, *Accounting and Reporting by Insurance Enterprises*; SFAS No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments;* and SFAS No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts;* and American Institute of Certified Public Accountants Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*.

- SFFAS No. 5, paragraph 121, requires that all components of the liability for future policy benefits (i.e., the net-level premium reserve for death and endowment policies and the liability for terminal dividends) should be separately disclosed in a footnote with a description of each amount and an explanation of its projected use and any other potential uses (e.g., reducing premiums, determining and declaring dividends

available, or reducing federal support in the form of appropriations related to administrative cost or subsidies).

Commitments and Contingencies

Certain disclosed information on major commitments and contingencies in the notes to the CFS was inconsistent with disclosed information in individual agencies' financial statements. Examples of such inconsistencies are as follows:

- Treasury did not disclose $114 billion in the notes to the CFS for war risk insurance. DOT provided temporary war risk insurance to U.S. air carriers whose coverage was canceled following the terrorist attacks on September 11, 2001. DOT disclosed $114 billion of war risk insurance in its notes to the financial statements, but Treasury did not disclose similar information in the notes to the CFS. Also, this information was included by DOT in the Treasury FACTS database. The risk of loss involving this type of insurance is unknown, but another terrorist attack against the United States could result in major claims.

- Treasury improperly disclosed $4.5 billion in unadjudicated claims for Commerce in the notes to the CFS. In its financial statements, Commerce disclosed that the exact amount of these claims against the U.S. government is unknown and the range of loss, which may exceed $4.5 billion as of September 30, 2002, cannot be estimated. Because Commerce had disclosed that it could not estimate the loss from unadjudicated claims, which was proper, Treasury should not have disclosed an amount in the notes to the CFS. Disclosing information in the CFS that is inconsistent with information in an agency's financial statements may confuse users of the CFS or lead them to reach a wrong conclusion.

Treasury did not disclose sufficient information regarding the nature of certain major commitments and contingencies in the notes to the CFS. For example, Treasury did not clearly disclose in the notes to the CFS information regarding a possible capital investment requirement of TVA. The Environmental Protection Agency (EPA) had taken judicial and administrative actions against TVA that could require TVA to invest an estimated $3 billion to purchase equipment in order to comply with the Clean Air Act and conform to EPA's pollution control requirements. TVA is challenging this action. Treasury disclosed this $3 billion in the notes as an "administrative order against TVA" without providing the additional detail that the order represents a capital investment for compliance with the

Clean Air Act and pollution control. The lack of such a detailed discussion about what the contingency represents could be misleading to readers of the CFS.

Collections and Refunds of Federal Revenue

The disclosure for collections and refunds of federal revenue departed from the following disclosure requirements of FASAB's SFFAS No. 7, *Concepts for Reconciling Budgetary and Financial Accounting:*

- Paragraph 64, among other things, requires collecting entities to disclose the basis of accounting when the application of the general rule results in a modified cash basis of accounting. The CFS incorrectly states that the nonexchange revenues are reported on a modified cash basis of accounting when actually they are reported on a cash basis.

- Paragraph 69.2 requires collecting entities to provide in the other accompanying information any relevant estimates of the annual tax gap that become available as a result of federal government surveys or studies. The tax gap is defined as taxes or duties due from noncompliant taxpayers or importers. Amounts reported should be specifically defined (e.g., whether the tax gap includes or excludes estimates of taxes due on illegally earned revenue). Appropriate explanations of the limited reliability of the estimates also should be provided. Cross-references should be made to portions of the tax gap due from identified noncompliance assessments and preassessment work in process.

Dedicated Collections

The note disclosure for dedicated collections departed from the disclosure requirements of SFFAS No. 7, Part I, *Accounting for Revenue and Other Financing Sources*, paragraph 85, by not including the following:

- condensed information about assets and liabilities showing investments in Treasury securities, other assets, liabilities due and payable to beneficiaries, other liabilities, and fund balance;

- condensed information on net cost and changes to fund balance, showing revenues by type (exchange/nonexchange), program expenses, other expenses, other financing sources, and other changes in fund balance; and

- any revenues, other financing sources, or costs attributable to the fund under accounting standards but not legally allowable as credits or charges to the fund.

Indian Trust Funds

The note disclosure for Indian trust funds departed from the following disclosure requirements of SFFAS No. 7, Part I, *Accounting for Revenue and Other Financing Sources*, paragraph 85, by not including the following:

- a description of each fund's purpose, how the administrative entity accounts for and reports the fund, and its authority to use those collections;
- the sources of revenue or other financing for the period and an explanation of the extent to which they are inflows of resources to the government or the result of intragovernmental flows;
- condensed information about assets and liabilities showing investments in Treasury securities, other assets, liabilities due and payable to beneficiaries, and other liabilities;
- condensed information on net cost and changes to fund balance, showing revenues by type (exchange/nonexchange), program expenses, other expenses, other financing sources, and other changes in fund balance; and
- any revenues, other financing sources, or costs attributable to the fund under accounting standards, but not legally allowable as credits or charges to the fund.

Social Insurance

The disclosure for social insurance departed from the following requirements of SFFAS No. 17, *Accounting for Social Insurance:*

- Paragraph 31 requires the program descriptions for Hospital Insurance and Supplementary Medical Insurance and an explanation of trends revealed in Chart 11: Estimated Railroad Retirement Income (Excluding Interest) and Expenditures 2002-2076.

- Paragraph 24 requires a description of statutory or other material changes, and the implications thereof, affecting the Medicare and Unemployment Insurance programs after the current fiscal year.

- Paragraph 25 requires the significant assumptions used in making estimates and projections regarding the Black Lung and Unemployment Insurance programs.

- Paragraph 32(1)(b) requires the total cash inflow from all sources, less net interest on intragovernmental borrowing and lending and the total cash outflow to be shown in nominal dollars for the Hospital Insurance program.

- Paragraph 32(1)(a) requires the narrative to accompany the cash flow data for Unemployment Insurance. This narrative should include the identification of any year or years during the projection period when cash outflow exceeds cash inflow, without interest, on intragovernmental borrowing or lending. In addition, the presentation should include an explanation of material crossover points, if any, where cash outflow exceeds cash inflow and the possible reasons for this.

- Paragraphs 27(3)(h) and 27(3)(j) require the estimates of the fund balances at the respective valuation dates of the social insurance programs (except Unemployment Insurance) to be included for each of the 4 preceding years. Only 1 year is shown.

- Paragraph 32(4) requires individual program sensitivity analyses for projection period cash flow in present value dollars and annual cash flow in nominal dollars. The CFS includes only present value sensitivity analyses for Social Security and Hospital Insurance. Paragraph 32(4) states that, at a minimum, the summary should present Social Security, Hospital Insurance, and Supplementary Medical Insurance separately.

- Paragraph 27(4)(a) requires the individual program sensitivity analyses for Social Security and Hospital Insurance to include an analysis of assumptions regarding net immigration.

- Paragraph 27(4)(a) requires the individual program sensitivity analysis for Hospital Insurance to include an analysis of death rates.

- The actuarial present value information for the Railroad Retirement Board should not include financial interchange income (intragovernmental income from Social Security).

Nonfederal Physical Property

The information included in Stewardship Information for nonfederal physical property departed from the following disclosure requirements of SFFAS No. 8, *Supplementary Stewardship Reporting*, paragraph 87:

- The annual investment, including a description of federally owned physical property transferred to state and local governments, must be disclosed. This information should be provided for the year ended on the balance sheet date as well as for each of the 4 preceding years. If data for additional years would provide a better indication of investment, reporting of the additional years' data is encouraged. Reporting should be at a meaningful category or level.

- A description of major programs involving federal investments in nonfederal physical property, including a description of programs or policies under which noncash assets are transferred to state and local governments, is to be provided.

Human Capital

The information in stewardship information for human capital departed from the disclosure requirements of SFFAS No. 8, *Supplementary Stewardship Reporting*, paragraph 94, by not including the following:

- a narrative description and the full cost of the investment in human capital for the year being reported on as well as the preceding 4 years (if full cost data are not available, outlay data can be reported);

- the full cost or outlay data for investments in human capital at a meaningful category or level (e.g., by major program, agency, or department); and

- a narrative description of major education and training programs considered federal investments in human capital.

Research and Development

The information in stewardship information for research and development departed from the disclosure requirements of SFFAS No. 8, *Supplementary Stewardship Reporting*, paragraph 94, by not including the following:

- The annual investment[1] made in the year ended on the balance sheet date as well as in each of the 4 years preceding that year must be reported. If data for additional years would provide a better indication of investment, reporting of the additional years' data is encouraged. In those unusual instances when entities have no historical data, only current reporting year data need be reported. Reporting must be at a meaningful category or level—for example, a major program or department.

- A narrative description of major research and development programs is to be included.

Deferred Maintenance

The required supplemental information for deferred maintenance departed from the following disclosure requirements of SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, paragraphs 83 and 84:

- Method of measuring deferred maintenance for each major class of PP&E should be included.

- If the condition assessment survey method of measuring deferred maintenance is used, the following should be presented for each major class of PP&E: (1) description of requirements or standards for acceptable operating condition, (2) any changes in the condition requirements or standards, and (3) asset condition and a range estimate of the dollar amount of maintenance needed to return the asset to its acceptable operating condition.

- If the total life-cycle cost method is used, the following should be presented for each major class of PP&E: (1) the original date of the maintenance forecast and an explanation for any changes to the

[1]As defined in this standard, "annual investment" includes more than the annual expenditure reported by character class for budget execution. Full cost shall be measured and accounted for in accordance with SFFAS No. 4, *Managerial Cost Accounting Standards for the Federal Government*.

forecast, (2) prior year balance of the cumulative deferred maintenance amount, (3) the dollar amount of maintenance that was defined by the professionals who designed, built, or managed the PP&E as required maintenance for the reporting period, (4) the dollar amount of maintenance actually performed during the period, (5) the difference between the forecast and actual maintenance, (6) any adjustments to the scheduled amounts deemed necessary by the managers of the PP&E, and (7) the ending cumulative balance for the reporting period for each major class of asset experiencing deferred maintenance.

- If management elects to disclose critical and noncritical amounts, the disclosure is to include management's definition of these categories.

Risk Assumed

The note disclosure for stewardship responsibilities departed from disclosure requirements of SFFAS No. 5, paragraph 106, related to the risk assumed for federal insurance and guarantee programs. Risk assumed information is important for all federal insurance and guarantee programs (except social insurance, life insurance, and loan guarantee programs) and is generally measured by the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force. Paragraph 106 states that when financial information pursuant to FASB's standards on federal insurance and guarantee programs conducted by government corporations is incorporated in general purpose financial reports of a larger federal reporting entity, the entity should report as required supplementary information[2] what amounts and periodic change in those amounts would be reported under the "risk assumed" approach.

[2]In July 2003, SFFAS No. 25 reclassified "risk assumed" from Required Supplementary Stewardship Information to Required Supplementary Information.

Comments from Department of the Treasury and the Office of Management and Budget

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Jeffrey C. Steinhoff
Managing Director, Financial Management and Assurance
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Steinfoff:

We appreciate the opportunity to comment on the draft management report based on your FY2002 audit of the *Financial Report of the United States Government (Financial Report)*. We reviewed this draft along with the associated attachments that will be included in your Financial Audit Report, *Process for Preparing the Consolidated Financial Statements for the U.S. Government Needs Improvement*. The report identified many recommendations that will improve the usefulness and accuracy of the Financial Report. We are already incorporating many of them into our new system and processes that are being developed for preparing the FY04 Financial Report. We will consider the other recommendations as we continue the design and implementation of the new compilation process.

There are two significant recommendations in your report with which we disagree.

Net Position. Treasury has decided not to include in the new compilation process the procedure that would require agencies to split their net position between Federal and Non-federal. This process was originally recommended as part of the Consolidated Financial Statement Improvement project. However, we were unable to develop a procedure that agencies could use to provide this split. In addition the net position split would not identify errors due to unreported miscellaneous receipts, buy/sell transactions, transfers-in and out, different basis of accounting, unbilled receivables, or other interagency transactions known to impact the unreconciled net position transactions.

Statements of Changes in Cash Balance from Unified Budget and Other Activities. This statement includes information derived from Treasury's Central Accounting System rather than from agency data (i.e., the Statement of Budgetary Resources (SBR)). You have suggested that agency data be used to prepare receipts and outlays used in our report. While we agree that management controls over amounts reported by agencies in the SBRs should be strengthened, we do not agree that the SBR data should be used to prepare our report or rises to an audit opinion issue for the government-wide report. Treasury maintains the data used to compute outlays and receipts used in the President's budget. This same information is also required by the accounting standard SFFAS 25(5). Therefore, it would not be appropriate to develop a time consuming and costly methodology to gather the SBR data for financial reporting purposes.

We would also request that the recommendations in your report that are directed to Treasury for action related to (1) management representation letters be directed to the Office of Management and Budget (OMB) and (2) legal representation letters be directed to OMB and the Department of Justice.

See comment.

We requested that GAO provide a Management Letter because we believe it will be very helpful in identifying and addressing the audit findings. This process would be even more helpful to Treasury and OMB in subsequent years if the Management Letter is furnished in a time frame shortly after GAO completes its audit work, or within thirty days, so there will be opportunities to make changes before the fiscal year ends.

We look forward to continuing to work through these issues with you in our mutual effort to improve the Government's financial reporting. We will be scheduling a meeting with your staff to discuss other technical matters associated with your report.

Sincerely,

Linda M. Springer
Controller
Office of Management and Budget

Donald V. Hammond
Fiscal Assistant Secretary
Treasury Department

GAO Comment

Treasury and OMB did not schedule a meeting or provide us with any technical comments on this report.

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