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# MANAGERIAL COST ACCOUNTING PRACTICES

## Departments of Labor and Veterans Affairs

Statement of Robert E. Martin, Director  
Financial Management and Assurance





Highlights of [GAO-05-1031T](#), a report to Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives

## Why GAO Did This Study

In the past 15 years, a number of laws, accounting standards, system requirements, and related guidance have emphasized the need for cost information in the federal government, establishing requirements and accounting standards for managerial cost accounting (MCA) information. Among them was the Federal Financial Management Improvement Act of 1996 (FFMIA), which required Chief Financial Officers Act agencies' systems to comply substantially with federal financial management systems requirements and federal accounting standards, including managerial cost accounting standards.

In light of these requirements, the Chairman asked GAO to determine how federal agencies generate MCA information and how government managers use that information to support their decision making and provide accountability. GAO briefed subcommittee staff on its work at the Departments of Labor (DOL) and Veterans Affairs (VA) on July 15 and issued a report on its findings that included recommendations on September 2, 2005 ([GAO-05-1013R](#)).

[www.gao.gov/cgi-bin/getrpt?GAO-05-1031T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-1031T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Robert Martin at (202) 512-6131 or [martinr@gao.gov](mailto:martinr@gao.gov).

# MANAGERIAL COST ACCOUNTING PRACTICES AT DEPARTMENTS OF LABOR AND VETERANS AFFAIRS

## Departments of Labor and Veterans Affairs

### What GAO Found

The principal purpose of managerial cost accounting (MCA) is to determine the cost of achieving performance goals, delivering programs, and pursuing other activities. This allows the organization to assess whether the cost is reasonable or to establish a baseline for comparison with what it costs others to do similar work. Although the factors analyzed depend on the operations and needs of the organization, reliable financial and nonfinancial data are critical. Without reliable data, the analysis can be distorted. Strong leadership that provides a structure for good controls and assessments of system operations helps set the conditions for data reliability. GAO found that DOL and VA had different approaches to implementing MCA systems and that both had some control weaknesses with respect to the quality of certain of the data they used and documenting policy and procedures.

DOL, under the direction of its Chief Financial Officer, implemented a departmentwide MCA system upon which 15 of its 18 component agencies built MCA models tailored to meet their respective needs. Component agencies continue to refine their models, and DOL is updating its policies and procedures to reflect the new system and processes. A formal post-implementation review of the system is not planned, however. While DOL has various controls in place over financial data, GAO found that controls over nonfinancial data need further attention to ensure reliability. DOL officials are taking additional steps to address these issues.

VA adopted a different approach and does not have a departmentwide system. Instead, it has delegated this responsibility to the individual components. Of the two largest components, only the Veterans Health Administration (VHA) had an operating MCA system. The Veterans Benefits Administration had discontinued use of its MCA system in 2003 because of system credibility and personnel issues. GAO found that the VHA system uses data from nearly 50 feeder systems. Other auditors have raised data reliability concerns with respect to certain of these systems. Raising concerns about data reliability in one of the VHA systems, the VA Office of Inspector General stated that this might be a systemic problem. In addition, GAO found that VHA was unable to produce documentation of the system readily, which could inhibit efforts to determine whether costs are properly assigned. With no MCA system overall at VA, it uses manual cost-finding techniques for external reporting. VA's independent financial statement auditor found control weaknesses in this manual process, and VA officials stated that documentation of compilation procedures for its Statement of Net Costs was not current.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to talk about managerial cost accounting practices (MCA) at the Department of Labor and Department of Veterans Affairs. This topic is all about efficiency, productivity, and the best use of resources. Taxpayers expect us to act in their best interests in managing their money, and managerial cost accounting can help us to do so. To that end, over the past 15 years, a number of laws, accounting standards, system requirements, and related guidance have emphasized the need for cost information and cost management in the federal government, establishing requirements and accounting standards for MCA at federal agencies.

The Chief Financial Officers (CFO) Act of 1990<sup>1</sup> contains several provisions related to managerial cost accounting, one of which states that an agency's CFO should develop and maintain an integrated accounting and financial management system that provides for the development and reporting of cost information and the systematic measurement of performance. The Federal Financial Management Improvement Act of 1996 (FFMIA)<sup>2</sup> required CFO Act agencies' systems to comply substantially with federal accounting standards and federal financial management systems requirements. Federal managerial cost accounting standards,<sup>3</sup> which became effective in fiscal year 1997, provide a conceptual framework and standards for MCA implementation. The Joint Financial Management Improvement Program's (JFMIP)<sup>4</sup> System Requirements for Managerial Cost Accounting,<sup>5</sup> published in 1998, builds upon, and provides an approach to implement requirements for cost accounting set forth in the CFO Act and federal MCA standards.

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<sup>1</sup> Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990).

<sup>2</sup> Pub. L. No. 104-208, div. A., § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996).

<sup>3</sup> Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*.

<sup>4</sup> In 2005, JFMIP's responsibilities for financial management and policy oversight were realigned to the Office of Management and Budget, the Office of Personnel Management, and the Chief Financial Officers Council.

<sup>5</sup> Joint Financial Management Improvement Program, *System Requirements for Managerial Cost Accounting* (Feb. 1998).

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MCA essentially entails answering a very simple question: How much is it costing to do something, be it some extensive overall or program effort or the incremental and iterative efforts associated with a project or activity? As such, it involves accumulating and analyzing both financial and nonfinancial data<sup>6</sup> to determine the costs of achieving performance goals, delivering programs, and pursuing other activities. The principal purpose, of course, is to assess how much it is costing to do whatever is being measured, thus allowing assessments of whether that seems reasonable, or perhaps establishing a baseline for comparison with what it costs others to do similar work or achieve similar performance. The factors analyzed and the level of detail depends on the operations and needs of the organization. As cornerstones of this type of analysis, reliable financial and nonfinancial data are critical, because if either is wrong the resulting analysis can give a distorted view of how well an organization is doing.

In light of the requirements for federal agencies to prepare MCA information and your interest in financial management and accountability, you asked us to determine how federal agencies generate MCA information and how government managers use that information to support their decision making and provide accountability. We will be looking at 10 agencies in a four-phase study of this issue. DOL and VA are the first agencies we reviewed.

To respond to this first phase of your request, we interviewed officials at DOL and VA and reviewed documentation on the status of MCA system implementation including successes and obstacles to managerial costing. We also reviewed departmental guidance and looked for evidence of DOL and VA leadership and commitment to the implementation of entitywide cost management practices. Using the Standards for Internal Control in the Federal Government<sup>7</sup> as a guide, we examined DOL and VA internal controls over the reliability of financial and nonfinancial information used in MCA. To determine how DOL and VA managers used cost information to support managerial decision making and provide accountability, we interviewed agency officials, identified examples, and reviewed documentation provided by the departments. We briefed your staff on the

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<sup>6</sup> Nonfinancial data measure the occurrences of activities and can include, for example, hours worked, units produced, grants managed, inspections conducted, or people trained.

<sup>7</sup> GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

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results of our review of these departments on July 15, 2005, and issued a report to you highlighting that work on September 2, 2005.

We found that DOL and VA adopted different approaches for pursuing MCA. DOL implemented a departmentwide system upon which 15 of its 18 component agencies have built MCA models tailored to their respective needs. At VA, responsibility for MCA implementation has been vested with individual component agencies. I will talk first about DOL and then about VA.

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## Department of Labor

As you know, DOL's mission is to foster and promote the welfare of our country's job seekers, wage earners, and retirees. For fiscal year 2005, DOL has a budget of approximately \$51 billion. It employs nearly 17,000 people at 10 mission agencies and 8 support agencies.

DOL's initial MCA efforts in the form of pilots in 1999 were unsuccessful. Its current efforts were spurred, in part, by its Office of Inspector General's (OIG) findings in 2002 and 2003 that DOL's accounting system was not in substantial compliance with FFMIA because it did not meet the accounting standards regarding MCA requirements. The OIG recommended that DOL develop a comprehensive departmentwide MCA system implementation plan. Although DOL disagreed with the OIG conclusions, it did agree to focus more attention on MCA. DOL's Office of the Chief Financial Officer (OCFO) was assigned responsibility for MCA development.

DOL's new MCA system, referred to as Cost Analysis Manager (CAM), uses commercial software designed to collect and analyze agency financial, and labor distribution,<sup>8</sup> and performance data. According to DOL officials, CAM can provide management with information and reports concerning the costs, including most direct and indirect costs, of performance goals, activities, and outputs. They also said that CAM can provide integrated performance and financial information, trend analysis, benchmarking data, and "what if" analysis. Agency and OCFO personnel developed component-specific CAM models. These models are in place at all 10

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<sup>8</sup> Labor distribution is essentially the number of hours worked pursuing a particular performance goal, program, or other activity.

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mission agencies and 5 of the 8 support agencies.<sup>9</sup> DOL officials told us that the Secretary of Labor had discussed CAM regularly in monthly meetings with agency managers to emphasize the importance of MCA implementation.

The CAM system became operational in September 2004. DOL's component agencies continue to refine the models to meet their needs. In doing so, they learn about system capabilities while considering additional applications for CAM. DOL is updating its MCA policy and procedures to reflect newly developed systems and processes. DOL officials told us that component-specific cost model reference manuals would be distributed to components by the end of fiscal year 2005. The manuals will combine, in one resource, descriptions of the CAM methodology and assumptions and other documentation.

Planned systemwide refinements include (1) automating the data extraction and import process, (2) integrating budget and performance data, and (3) adding programs and outputs not included in baseline models. However, a post-implementation review (PIR) of the new CAM system was not planned. A formal PIR would document the evaluation criteria and differences between estimated and actual costs and benefits as well as opportunities for management to extract "lessons learned" and improve control processes.

DOL's CAM incorporates financial information from its core accounting system, while nonfinancial information, such as hours worked on particular projects or the number of people trained, is obtained from other sources. There are various controls over financial data in place, including (1) annual audits of financial statements, which have had unqualified opinions beginning with fiscal year 1997; (2) reconciliations of CAM to the general ledger system; and (3) quarterly attestations by component agencies' senior officials concerning the adequacy of internal controls, the accuracy of transaction recording, and regulatory compliance.

According to DOL, the process of building and updating the MCA models includes supervisory review of nonfinancial data, such as labor distribution and performance data, as well as review by line managers,

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<sup>9</sup> The three agencies without MCA models represent approximately 0.1 percent of the department's budget. Initially, implementing MCA at the three smaller support agencies was not deemed a priority because of their small size and the nature of the support services they provide.

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senior managers, and program administrators. Controls over nonfinancial labor distribution and performance data need further attention, however. In its fiscal year 2004 performance plan, DOL identified validation of such data as one of its challenges. In the DOL 2004 Performance and Accountability Report, the Inspector General stated that prior year audit work identified high error rates in grantee-reported performance data at the Employment and Training Administration.<sup>10</sup> The OIG also raised concerns about DOL using those data for decision making. DOL officials recognize the importance of this type of data to cost analysis and told us that they are implementing additional data validation systems to address these issues.

DOL's component agencies are focusing on further refining their respective models to help manage programs and resources more effectively. Even though CAM was only recently implemented, DOL agencies identified many uses for CAM data. For example, DOL officials said they have begun to use CAM data to identify and analyze (1) program costs across regions; (2) comparative costs of grant management activities by type of grant; (3) full administrative costs related to the development of policies, regulations, and legislative proposals; (4) unit costs of training and employment programs; and (5) budget justifications and resource allocations.

VA, as I will discuss now, has taken a different approach.

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## Department of Veterans Affairs

VA's mission is to administer laws that provide health care, financial assistance, burial benefits, and other services to veterans, their dependents, and their beneficiaries. For fiscal year 2005, VA's net budget authorization is about \$67 billion. Its two largest component agencies, in terms of budget and staff size, are the Veterans Health Administration (VHA) and the Veterans Benefits Administration (VBA). Its third and smallest administration is the National Cemetery Administration (NCA). With over 193,000 employees, VHA is VA's largest component. VHA health care facilities provide a broad spectrum of medical, surgical, and rehabilitative care. VBA has about 13,000 employees who process claims for VA benefits. NCA's staff of about 1,500 provides direction and oversight for 120 cemeteries.

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<sup>10</sup> The Employment and Training Administration's fiscal year 2005 budget authority represented nearly 91 percent of DOL's total.

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By design and policy, VA does not have an entitywide MCA model. According to department officials, each of the VA agencies has independently built a cost accounting system for identifying, accumulating, and assigning the costs of its outputs, though VBA discontinued use of its system in 2003. Officials told us that VA's financial management priority has been the removal of a material weakness that was identified by the independent auditors related to the lack of an integrated financial management system at the department.

VA did state that having a fully operational MCA model at each component was important to managerial decision making. Although VA has published cost accounting policy and guidance delegating implementation responsibility to component agencies, VA officials we interviewed could not identify examples of proactive department-level leadership to ensure that MCA systems were in place in the component agencies. Not surprisingly, the degree to which MCA had been embraced varied at VHA and VBA, the two component agencies we reviewed.<sup>11</sup>

VHA, VA's largest component in terms of number of employees, provides medical care to our country's veterans. It should be expected to routinely know its cost of care and has a system, referred to as the Decision Support System (DSS), for that purpose. According to VHA officials, DSS models significant VHA cost flows and activities. DSS facilitates cost and workload analyses of VHA's locations, programs, activities, and individual patients. It obtains data from 49 feeder sources, including VA's Financial Management System general ledger and VHA's Veteran's Health Information Systems and Technology Architecture (VistA).<sup>12</sup> DSS includes direct and indirect costs for VA hospitals and supporting organizations.

According to VA officials, DSS was used to generate cost information to support internal budgeting, resource allocation, performance measurement, fee reviews, and cost analysis for programs, activities, and outputs. For example, officials told us that a chief pharmacist's request for additional funds for high-cost providers and drugs used at a VA hospital was supported by a DSS analysis of the local pharmacy costs for that location. They said DSS was also used to compare the costs among the hospitals to determine where services can be provided at the lowest cost.

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<sup>11</sup> VHA and VBA accounted for 43 percent and 54 percent of VA's 2004 budget outlays, respectively.

<sup>12</sup> VistA is VHA's nonfinancial workload information system for hospitals.



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In one case, this kind of DSS information analysis was used in the decision-making process to consolidate inpatient psychiatric services. DSS is also used to determine the costs of services provided for individual customers, as DSS records allow information to be tracked for individual patients.

VA officials informed us that the extent and nature of DSS's use for management decision making varied from one medical facility to the next because of different levels of training among medical facility staff. VA's independent auditor found that some VHA medical centers were continuing to use cost data from Cost Distribution Report, an outdated cost accounting system, which was replaced by DSS and is not reliable because it is no longer maintained. According to the independent auditor, the data from these systems were used for a variety of purposes, including setting fees, budgeting and cost control, and contracting out decisions.<sup>13</sup>

As in any MCA system, the completeness and accuracy of the data in DSS depend on the quality of data from the feeder systems. Financial information included in DSS is subject to controls that help ensure data reliability. VA officials told us that they periodically reconcile DSS to the general ledger system, and provided an example of such a reconciliation. Annual audits of VA's annual financial statements, which are based on the same financial information that feeds DSS, have resulted in unqualified opinions for fiscal years 1999 through 2004. However, in its report on the audit of VA's fiscal year 2004 financial statements, the OIG stated that extensive efforts were required after the fiscal year end to overcome control weaknesses and produce auditable information. The OIG also stated that although these efforts resulted in materially correct financial statements, reliable information was not readily available during the year. These concerns about financial information reliability could extend to DSS financial data.

Further, both VA's OIG and independent auditor raised concerns about the quality of data from DSS nonfinancial feeder systems. In August 2004, the OIG reported that most of the legacy systems, such as VistA, at VA's Bay Pines Medical Center contained inaccurate data. The OIG also stated that this might be a systemic problem throughout VHA. According to that

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<sup>13</sup> This concern was reported to VA management in the IPA's letter dated November 4, 2004. In that letter, the IPA noted that this was a continuing issue that had been previously observed.

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report, VHA officials concurred with the OIG and agreed to take corrective action. Since VistA is among the 49 feeder sources for DSS, the independent auditor and OIG findings raise concerns about the quality of nonfinancial data in that system.

In addition, in its fiscal year 2004 management letter, the independent auditor noted an increasing shortage of information technology (IT) staff supporting VistA applications and related network infrastructures at the medical centers. The independent auditor concluded that “[t]his loss of human capital and knowledge in the IT organizational structure places VA’s information and its processing capabilities at risk.” As mentioned previously, reliable financial and nonfinancial data are both critical in cost analysis because if either is wrong the resulting analysis can be distorted.

The VHA Decision Support Office, which is responsible for operating DSS, was unable to readily produce documentation of the mechanism used to assign indirect costs to cost objects in DSS. The lack of readily available system documentation could inhibit efforts to determine whether such costs are properly assigned and precludes an opportunity to provide guidance for employees using the system, especially new employees.

VBA, VA’s second largest component, discontinued the use of its Activity Based Costing (ABC) system in March 2003 because of the loss of key personnel, and because the ABC indirect cost distribution methodology, a central part of the ABC system, lacked credibility with some managers. Because VBA was not funding or promoting MCA at the time of our review, we pointed out to VBA officials the requirements for pursuing MCA and highlighted potential benefits of doing so, including some examples of using cost information at VHA. Subsequently, according to VA officials, the VBA CFO informed them that he would seek funding in VBA’s 2007 budget request to develop cost accounting capabilities.

At the department level, VA used manual cost-finding techniques to accumulate cost information to prepare the Statement of Net Cost and to support budgeting. This process, which uses Excel spreadsheets, can be burdensome, time consuming, and error prone when the roll-up process must be redone because of end-of-year auditor adjustments and edits. VA officials told us that the documentation of its Statement of Net Cost compilation procedures was not current. VA’s independent financial statement auditor reported control weaknesses in the agency’s manual process to prepare its annual financial statements.

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## Conclusions

In closing, Mr. Chairman, I want to emphasize that strong leadership in the departments will be required to implement managerial cost accounting across government. This is true regardless of whether the department wants a department-wide system or delegates responsibility for system development to component agencies. In either case, the leadership will need to focus on promoting the benefits of managerial cost accounting, monitoring its implementation, and establishing a sound system of controls to help ensure the reliability of the data used.

Although DOL's recent efforts to implement CAM were significantly boosted by its departmental leadership, maximizing CAM's contribution to improved management will require continuing improvements to system data reliability, system documentation, and assessments of system effectiveness.

VA's department-level leadership has not taken steps that ensured the implementation and continuation of MCA practices at VBA. While the DSS system is in place at VHA, documentation of system processes and controls and other auditors' concerns about the quality of data require attention in order to enhance the reliability of information for managerial decision making.

Our report made recommendations to the Secretary of Labor and the Secretary of Veterans Affairs that if fully implemented, should help improve data reliability, documentation, and implementation of appropriate MCA methodologies.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or members of the subcommittee may have.

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## Contact and Acknowledgments

For information about this statement, please contact Robert Martin at (202) 512-6131 or by e-mail at [MartinR@gao.gov](mailto:MartinR@gao.gov). Key contributors to this testimony were Jack Warner, Paul Begnaud, Lisa Crye, Dan Egan, Barbara House, Jerrica Kahle, Paul Kinney, Lisa Knight, Miguel Lujan, James Moses, Lori Ryza, Glenn Slocum, and Bill Wright.

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