



Testimony

Before the Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, Committee on Homeland Security and Government Affairs, U.S. Senate

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HUMAN CAPITAL

Aligning Senior Executives' Performance with Organizational Results Is an Important Step Toward Governmentwide Transformation

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Highlights of [GAO-06-1125T](#), testimony before the Subcommittee on Oversight of Government Management, the Federal Workforce and the District of Columbia, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The government's senior executives need to lead the way in transforming their agencies' cultures. Credible performance management systems—those that align individual, team, and unit performance with organizational results—can help manage and direct this process. In past work, GAO found that the performance management systems for senior executives fell short in this regard. In November 2003, recognizing that reforms were needed, Congress authorized a new performance-based pay system that ended the practice of giving annual pay adjustments to senior executives. Instead, agencies are to consider such factors as individual results and contributions to agency performance. If the Office of Personnel Management (OPM) certifies an agency's new performance system and the Office of Management and Budget (OMB) concurs, the agency has the flexibility to raise the pay of its highest performing senior executives above certain pay caps.

This testimony addresses (1) the performance management system's regulatory structure, (2) OPM's certification process and agencies' views of it, and (3) OPM's role in monitoring the system, and the number of agencies that have been certified to date. This statement is based on GAO's issued work, which included interviews with senior OPM officials, agency Chief Human Capital Officers and Human Resource officers, and reviews of agency documents.

www.gao.gov/cgi-bin/getrpt?GAO-06-1125T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Brenda S. Farrell at (202) 512-3604 or farrellb@gao.gov.

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What GAO Found

Overall, the regulations that OPM and OMB developed to administer a performance-based pay system for executives serve as an important step for agencies in creating an alignment or "line of sight" between executives' performance and organizational results. To qualify for the pay flexibilities included in the statute, OPM must certify and OMB must concur that an agency's performance management system meets nine certification criteria, including demonstrating that its performance management system aligns individual performance expectations with the mission and goals of the organization and that its system as designed and applied makes meaningful distinctions in performance. The certification criteria are generally consistent with key practices for effective performance management systems GAO identified that collectively create a line of sight between an individual's performance and an organization's success. To receive a full 2-calendar-year certification, an agency must document that its senior executive performance management system meets all nine of the criteria. Agencies can meet four of nine criteria and demonstrate that their system in design meets the remaining certification criteria to receive 1-year provisional certification and use the higher pay rates.

Two divisions in OPM, as well as OMB, independently review agencies' certification submissions. A number of agencies GAO contacted expressed concern over OPM's ability to communicate expectations, guidance, and deadlines to agencies in a clear and consistent manner. OPM officials agreed that agencies need better guidance and were working on improvements.

In monitoring agencies' performance management systems, OPM can suspend an agency's certification at any time with OMB concurrence if an agency is not complying with the certification criteria. According to OPM data, performance management systems at 24 agencies were certified during calendar year 2006. Of these, only the Department of Labor's system received full certification; the remaining systems received only provisional certification. These findings are not surprising. As GAO has noted in its past work, agencies could find it initially difficult to provide the necessary performance data to receive full certification. Going forward, it will be important for OPM to continue to monitor the certification process to help ensure that provisional certifications do not become the norm, and agencies develop performance management systems for their senior executives that meet all of OPM's requirements.

The new performance management system for the government's senior executives will help agencies align individual, team, and unit performance with organizational results. Although there have been some implementation challenges, what will be important is how OPM works with agencies to meet the certification criteria. Moreover, the lessons learned in implementing the senior executive performance management system can be applied to modernizing the performance management systems of employees at other levels.

Chairman Voinovich, Senator Akaka, and Members of the Subcommittee:

Thank you for the opportunity to be here today to discuss the federal government's implementation of pay-for-performance systems for the approximately 7,000 members of the Senior Executive Service (SES) and those in other senior positions. As we have consistently testified, and as the Subcommittee has recognized, an agency's human capital is its most important catalyst for transforming government to meet the current and emerging challenges of the 21st century. We have also highlighted how federal human capital systems designed in the past are outmoded and, in some cases, barriers to an agency's transformation.

In our earlier work on senior executive performance management, we noted how high-performing organizations have recognized that a critical success factor in fostering a results-oriented culture is a performance management system that creates a "line of sight" showing how unit and individual performance can contribute to overall organizational goals and helping them understand the connection between their daily activities and the organization's success. We also discussed how high-performing organizations understand that they need senior leaders who are accountable for results, drive continuous improvement, and stimulate and support efforts to integrate human capital approaches with organizational goals and related transformation issues.¹

In 2002, we reported that significant opportunities existed to strengthen agencies' efforts to hold senior executives accountable for results through their performance management systems.² In particular, we reported that more progress was needed in explicitly linking senior executives' performance expectations to the achievement of results-oriented organizational goals, fostering the necessary collaboration both within and across organizational boundaries to achieve results, and demonstrating a commitment to lead and facilitate change.

Over the past few years, Congress and the administration have sought to modernize senior executive performance management systems. In November 2003, Congress established a new performance-based pay

¹GAO, *Human Capital: Senior Executive Performance Management Can Be Significantly Strengthened to Achieve Results*, [GAO-04-614](#) (Washington, D.C.: May 26, 2004).

²GAO, *Results-Oriented Cultures: Using Balanced Expectations to Manage Senior Executive Performance*, [GAO-02-966](#) (Washington, D.C.: Sept. 27, 2002).

system as part of the National Defense Authorization Act for Fiscal Year 2004³ that is designed to provide a clear and direct linkage between performance and pay for the government's senior executives. Additionally, aspects of the legislation can help address two shortcomings with the previous pay system: pay compression, and the failure of agencies to make meaningful distinctions among senior executives' job performances. Pay compression occurred in part because the previous system had six pay levels. Because of pay caps and other factors, senior executives at the top three levels received essentially the same amount of base pay in a given year. For example, we reported that about 70 percent of SES members received the same basic pay due to compression in 2003.⁴ At the same time, the administration believed that agencies' performance management systems were not making meaningful distinctions in senior executives' performance as demonstrated by the large percentage that consistently received the highest ratings possible.

The new pay system ended the practice of giving annual across-the-board or locality pay adjustments to senior executives. Instead, agencies are to base pay adjustments for senior executives on individual results and contributions to the agency's performance by considering the individual's accomplishments and such things as unique skills, qualifications, or competencies of the individual and the individual's significance to the agency's mission and performance. The system also replaced the six SES pay levels with a single, open-range pay band. Further, agencies can apply for certification of their performance appraisal systems by the Office of Personnel Management (OPM), with Office of Management and Budget (OMB) concurrence. Once an agency is certified, it has the flexibility to raise the pay of its highest performing SES members above certain pay caps. As an example, those agencies with certified performance management systems can increase base pay to \$165,200 for 2006. This compares to a cap of \$152,000 for base pay for those agencies without certified systems. OPM and OMB jointly issued regulations establishing the criteria for obtaining this certification in July 2004.

In addition to SES employees, many agencies use senior employees with scientific, technical, and professional expertise, commonly known as senior-level (SL) and scientific or professional (ST) positions. SL/ST

³ Pub.L. No.108-136, Nov. 24, 2003.

⁴GAO, *Human Capital: Trends in Executive and Judicial Pay*, GAO-06-708 (Washington, D.C.: June 21, 2006).

positions have a lower maximum rate of basic pay than SES employees, and unlike the SES, their individual rate of pay does not necessarily have to be based on individual or agency performance. However, an agency may apply to OPM and OMB for certification of its SL/ST performance management system, and if the system is certified as making meaningful distinctions in relative performance, an agency may raise the total annual compensation maximum for SL/ST employees to the salary of the Vice President. However, certification does not affect the maximum rate of basic pay of SL/ST employees.

We believe the new senior executive pay-for-performance system is an important step in aligning individual, team, and unit performance with organizational results. Indeed, high-performing organizations have recognized that their performance management systems are strategic tools to help them manage on a day-to-day basis and achieve organizational goals in part by linking their senior executive performance management systems to their organizations' success. Moreover, the lessons learned from implementing the new senior executive pay system can inform efforts to modernize the pay systems under which other federal employees are compensated. Indeed, cascading aspects of this approach to other levels of employees can help agencies recognize and reward employee contributions and achieve the highest levels of individual performance.

In my remarks today, I will discuss (1) the regulatory structure of the senior executive pay system and the importance of achieving a line of sight between executives' performance and organizational success by linking pay with performance, (2) the agency certification process and agencies' views of it, and (3) OPM's role in evaluating and monitoring the system, and the number of agencies that have been certified to date.

Mr. Chairman, as you know, the Senate Committee on Homeland Security and Governmental Affairs and your Oversight of Government Management, the Federal Workforce, and the District of Columbia Subcommittee requested that we conduct a review of OPM to identify management challenges that could affect its ability to lead human capital reform efforts. As part of our review, we have interviewed or obtained written responses from all 23 members of the Chief Human Capital Officers Council (CHCO) and/or their corresponding agency human resource (HR) directors to gain a customer perspective of OPM's products and services and their views of OPM management challenges. We obtained agencies' views on their experiences with OPM's certification of SES pay-for-performance systems. Our forthcoming report on this work will be issued in November 2006 and will include the agencies' experiences with

the certification process, as well as recommended actions to enhance OPM's capacity to lead and implement human capital reform overall. My statement today is based on our issued products which were conducted in accordance with generally accepted government auditing standards.

The Regulatory Structure of the Senior Executive Performance Management System Helps Link Executives' Performance to Organizational Results

Overall, the regulations that OPM developed to administer a performance-based pay system for senior executives serve as a substantive and positive step for agencies in holding senior executives accountable for their performance and contributions to organizational success. The new senior executive pay system raises the cap on base pay and total compensation. For 2006, the caps are \$152,000 for base pay (Level III of the Executive Schedule) with a senior executive's total compensation not to exceed \$183,500 (Level I of the Executive Schedule). If an agency's senior executive performance management system is certified by OPM and OMB concurs, the caps are increased to \$165,200 for base pay (Level II of the Executive Schedule) and \$212,100 for total compensation (the total annual compensation payable to the Vice President).

To qualify for these flexibilities, agencies' performance management systems need to meet nine specified certification criteria, including demonstrating that the systems align individual performance expectations with the mission and goals of the organization and that its appraisal system as designed and applied makes meaningful distinctions in performance.

To receive a full 2-calendar-year certification, an agency must provide documentation that its senior executive performance management system meets all nine of the criteria. Otherwise, agencies can meet four of nine criteria and demonstrate that their system in design meets the remaining certification criteria to receive 1-year provisional certification and use the higher pay rates. Agencies with 1-year provisional certification must reapply annually, and agencies with full certification must reapply every 2 years. Those agencies with more than one performance management system for their senior executive employees are to certify each system separately.

The certification criteria are framed as broad principles designed to serve as guidelines to position agencies to use their performance management system(s) strategically to support the development of a strong

performance culture and the attainment of the agency's mission, goals, and objectives. The certification criteria are generally consistent with our body of work identifying key practices for effective performance management.⁵ Specifically, we identified key practices, including aligning individual performance expectations with organizational goals, linking pay to individual performance, and making meaningful distinctions in performance, that collectively create a line of sight between an individual's performance and an organization's success. These practices are reflected in the final certification criteria.

Key aspects of the OPM certification criteria, as outlined in the regulations, are as follows:

- (1) Alignment: Individual performance expectations must be linked to or derived from the agency's mission, strategic goals, program/policy objectives, and/or annual performance plan.
- (2) Consultation: Individual performance expectations are developed with senior employee involvement and must be communicated at the beginning of the appraisal cycle.
- (3) Results: Individual expectations describe performance that is measurable, demonstrable, or observable, focusing on organizational outputs and outcomes, policy/program objectives, milestones, etc.
- (4) Balance: Individual performance expectations must include measures of results, employee and customer/stakeholder satisfaction, and/or competencies or behaviors that contribute to outstanding performance.
- (5) Assessments and Guidelines: The agency head or a designee provides assessments of the performance of the agency overall, as well as each of its major program and functional areas.
- (6) Oversight: The agency head or designee must certify that (1) the appraisal process makes meaningful distinctions based on relative performance; (2) results take into account, as appropriate, the agency's performance; and (3) pay adjustments and awards recognize individual/organizational performance.

⁵GAO, *Results-Oriented Cultures, Creating a Clear Linkage between Individual Performance and Organizational Success*, GAO-03-488 (Washington, D.C.: Mar. 14, 2003).

(7) Accountability: Senior employee ratings (as well as subordinate employees' performance expectations and ratings for those with supervisor responsibilities) appropriately reflect employees' performance expectations, relevant program performance measures, and other relevant factors.

(8) Performance Differentiation: Among other provisions, the agency must provide for at least one rating level above Fully Successful (must include an Outstanding level), and in the application of those ratings, make meaningful distinctions among executives based on their relative performance.

(9) Pay Differentiation: The agency should be able to demonstrate that the largest pay adjustments and/or highest pay levels (base and performance awards) are provided to its highest performers, and that, overall, the distribution of pay rates in the SES rate range and pay adjustments reflects meaningful distinctions among executives based on their relative performance.

In commenting on OPM's draft regulations, we included suggestions intended to help agencies broaden the criteria to reinforce cultures that are results oriented, customer focused, and collaborative in nature. For example, we suggested that OPM require agencies to have their senior executives identify specific programmatic crosscutting, external, and partnership-oriented goals or objectives in their individual performance plans to help foster the necessary collaboration, interaction, and teamwork to achieve results.

Further, based on our previous testimony that performance management processes need to assure reasonable transparency,⁶ we noted the new performance management system should have adequate safeguards to ensure fairness and guard against abuse.⁷ Specifically, we suggested that OPM require agencies to build in safeguards as part of their senior executive performance management systems when linking pay to performance. For example, communicating the overall results of the performance management decisions to the senior executives, while

⁶ GAO, *Defense Transformation: Preliminary Observations on DOD's Proposed Civilian Personnel Reforms*, [GAO-03-717T](#) (Washington, D.C.: Apr. 29, 2003), p. 8.

⁷ GAO, *Human Capital: Implementing Pay for Performance at Selected Personnel Demonstration Projects*, [GAO-04-83](#) (Washington, D.C.: Jan. 23, 2004).

protecting individual confidentiality, could help enhance the transparency of the performance management process. We also recognized that scalability needs to be considered, and that small agencies might face difficulties communicating overall results of the performance management process while protecting the confidentiality of the fewer numbers of senior executives. In response, OPM changed some aspects of its criteria by incorporating these suggestions into the interim final regulations.

The Process for Certifying Agencies' Submissions

Agencies can submit their applications to OPM for certification anytime during the year. If fully certified, the certification is good for the remainder of the calendar year in which the agency applied, as well as all of the following calendar year. If provisionally certified, an agency's certification is only good for the calendar year in which it applied. For example, if an agency is provisionally certified in October 2005, its certification would expire in December 2005. To ensure the agency's submission is complete, the agency's OPM contact—the Human Capital Officer (HCO)—first verifies that the application contains the required materials and documents. If complete, the HCO sends copies to the two OPM divisions responsible for reviewing the application, the Human Capital Leadership and Merit System Accountability (HCLMSA) division and the Strategic Human Resources Policy (SHRP) division, and an additional copy to OMB. An agency's submission is reviewed independently by representatives within HCLMSA and SHRP in an attempt to bring different organizational perspectives to the review.

A submission is reviewed against the nine certification criteria, but each review team has its own method for analyzing the application. After an initial examination, the reviewers from HCLMSA and SHRP hold an informal meeting to discuss the submission. The reviewers meet again in a formal panel after a more thorough review, and this time they are joined by the HCO. This panel decides whether they have enough information to reach a certification decision about the agency. If the panel concludes there is not enough information to reach a decision, the HCO will request that the agency provide any missing or additional supporting information. If the panel decides there is sufficient information to reach a decision, it will either certify or reject the application.

When an application is rejected, the HCO works with the agency to help modify its appraisal system so that it meets the criteria. If the application is approved, the HCO contacts OMB for concurrence. OMB uses the same nine criteria to evaluate agency applications, but primarily focuses on measures of agency performance. If OMB concurrence is not achieved, the

HCO works with the agency to address OMB's concerns until resolution is reached. Once OMB concurs, the Director of OPM certifies the agency's appraisal system and the HCO provides additional comments to the agency on their system and identifies any improvement needs. For example, these comments may direct the agency to focus more on making meaningful distinctions in performance.

Agencies' Experience in Implementing the Senior Executive Pay System Highlights Areas Where Improvements Might be Needed

In our ongoing work on OPM's capacity to lead and implement human capital reform, we asked agency chief human capital officers (CHCO) and human resource (HR) directors to describe their experiences with OPM's administration of the senior executive pay-for-performance certification process. As the Comptroller General testified before this Subcommittee in June 2006,⁸ we heard a number of concerns from agencies regarding OPM's ability to communicate expectations, guidance, and deadlines to agencies in a clear and consistent manner. When the senior executive certification process began in 2004, OPM provided agencies with limited guidance for implementing the new regulations. OPM's initial guidance consisted of a list of documents required for provisional and full certification and a sample cover letter to accompany each application. The lack of more specific guidance created confusion as agencies attempted to interpret the broadly defined regulatory criteria and adjust to the requirements for certification. Officials at a majority of the CHCO Council agencies told us they did not have enough guidance to properly prepare for certification. As a result, agencies did not fully understand what was required in the regulations to receive certification.

For example, one official noted that while OPM tries to point agencies in the right direction, it will not give agencies discrete requirements. This leads to uncertainty about what agencies must and should demonstrate to OPM. Some CHCOs and HR directors also told us that, in some cases, OPM changed expectations and requirements midstream with little notice or explanation. However, OPM explains that it intentionally allowed some ambiguity in the regulations for the new senior executive appraisal system, in an attempt to provide agencies with management flexibilities. A senior OPM official said OPM did not provide agencies with "best practices"

⁸GAO, *Office of Personnel Management: OPM is Taking Steps to Strengthen Its Internal Capacity for Leading Human Capital Reform*, [GAO-06-861T](#) (Washington, D.C: June 27, 2006).

examples because OPM did not want agencies to think there was only one “right” way to get certified.

Agencies also indicated that because OPM did not issue guidance for calendar year 2006 submissions until January 5, 2006, some were unable to deliver their submissions to OPM before the beginning of the calendar year. Further, OPM clarified this guidance in a January 30, 2006, memorandum to agencies, telling agencies that senior executive performance appraisal systems would not be certified for calendar year 2006 if the performance plans did not hold senior executives accountable for achieving measurable business outcomes. As a result, agencies had to revise their submissions, where necessary, to meet OPM’s additional requirements.

Some agencies indicated that OPM’s late issuance of guidance also created an uneven playing field among agencies, as those that chose to wait until OPM issued guidance before applying for certification were unable to give their senior executives higher pay, while those who did not wait got certified sooner. OPM officials we spoke with about this agreed that they need to be able to provide clear and consistent guidance to agencies and said they are working to improve this. Further, they said their evaluation of agencies’ submissions is evolving as their understanding of the senior executive certification criteria is increasing.

OPM’s Role in Evaluating and Monitoring the Pay-for-Performance System

The regulations include several positive internal checks and balances that should help maintain the rigorous application of the new senior executive pay system. As I noted earlier, agencies granted full certification are to have their systems renewed for an additional 2 calendar years and agencies granted provisional certification are to reapply for certification after 1 calendar year in order to continue setting the rate of basic pay for senior executives at the higher level. In addition, OPM can suspend certification at any time during the certification period if it determines, with OMB concurrence, that the agency’s system is not in compliance with the certification criteria. OPM’s regulations also require review of each senior executive’s rating by a performance review board appointed by the agency head. As noted above, the regulations also require oversight of the performance appraisal system by the agency head who must certify that the system makes meaningful distinctions in relative performance.

According to OPM data, 26 performance management systems at 24 agencies were certified during calendar year 2006.⁹ Of these 26, only the Department of Labor's system received full certification. As of September 19, 2006, the remaining 25 systems received only provisional certification. These findings are not surprising. In our April 2005 testimony before this Subcommittee, we stated that a number of agencies would be challenged in the short term to provide the necessary performance data on their senior executives in order to receive full certification or to maintain their certification (agencies must provide 2 years of performance rating and bonus data showing that meaningful distinctions in senior executive performance were made to qualify).¹⁰ Other factors might also be at work. For example, a number of agencies have told us that the certification process is burdensome. One agency said that OPM's requirements for the certification of a submission are time intensive, laborious, and can disrupt an agency's recruitment and retention efforts.

As we also noted at the April 2005 hearing, OPM will need to carefully monitor the implementation of agencies' performance management systems, especially those that have provisional certification. This is because, as I have stated earlier, agencies with provisional certification can still receive the flexibilities of the new pay system, even though they do not meet all of OPM's certification requirements. In other words, agencies can receive the benefits of the new pay-for-performance system without meeting all of its requirements and safeguards. We believe that, going forward, it will be important for OPM to continue to monitor the certification process, determine whether any obstacles are impeding agencies from receiving full certification, and take appropriate measures to address them. These actions will help ensure that agencies continue to make substantive progress toward modernized performance management systems, and that provisional certifications do not become the norm.

Once agencies have provisional or full certification, OPM monitors senior executive performance appraisal systems by measuring the distributions of agencies' performance ratings and pay. This information helps OPM

⁹ An agency may have multiple performance management systems for senior employees—including SES and SL/ST members—and an agency must apply to OPM for certification of each system separately. In 2006, the National Aeronautics and Space Administration received separate certification for its Inspector General's Office and the Department of Defense received separate certification for its SL/ST systems.

¹⁰ GAO, *Human Capital: Agencies Need Leadership and the Supporting Infrastructure to Take Advantage of New Flexibilities*, [GAO-05-616T](#) (Washington, D.C.: Apr. 21, 2005).

determine if agencies are making meaningful distinctions among the performance of their senior executives. Such distinctions are important because effective performance management requires the organization's leadership to make meaningful distinctions between acceptable and outstanding performance and appropriately reward those who perform at the highest level.

In its Report on Senior Executive Pay for Performance for Fiscal Year 2005, OPM stated that the data indicate that federal agencies are taking seriously the requirement to develop rigorous appraisal systems and to make meaningful distinctions in performance ratings and pay. All reporting agencies have moved away from pass/fail appraisal systems and now have at least one performance level above "fully successful." In 2005, 43 percent of career SES governmentwide were rated at the highest performance level, compared to 75 percent in 2003 prior to the implementation of the SES pay-for-performance system. Further, OPM reported for fiscal year 2005 that the percentage of SES rated at the highest performance level declined 16 percent from the prior year. OPM also reported that the largest increases in salary went to SES rated at the highest performance level. Although SES pay and performance award amounts vary by agency based on factors such as compensation strategy, funding, and agency performance levels, OPM believes these general trends suggest a further refinement may be occurring in the process of distinguishing outstanding performers.

Concluding Remarks

As we have said in our prior reports and testimonies, senior executives need to lead the way in transforming their agencies' cultures to be more results oriented, customer focused, and collaborative in nature. Credible performance management systems, specifically those that (1) align individual, team, and unit performance to organizational results; (2) contain built-in safeguards; and (3) are effectively implemented, can help manage and direct this process.

The pay-for-performance system for the government's senior executives that I have discussed today is an important milestone on the march toward modern compensation systems that are more market based and performance oriented. Although OPM and agencies have encountered various challenges in implementing the system, such challenges are not surprising given the cultural shift that the new system represents. Moreover, just 2 years have passed since OPM issued its regulations for certifying agencies' pay-for-performance systems, and some growing pains are to be expected given agencies' lack of experience with performance

management systems that meet OPM's requirements. Moving forward, what will be important is how OPM works with agencies to provide the tools and resources they need to design and implement performance management systems that meet the certification criteria in as streamlined a fashion as possible.

The lessons learned in implementing the senior executive pay-for-performance system will be critical to modernizing the performance management systems under which other federal employees are compensated. In particular, establishing an explicit line of sight between individual, team, and unit performance and organizational success, as well highlighting opportunities to improve guidance, communications, transparency, and safeguards, will serve the government well moving forward. We stand ready to assist OPM and Congress in exploring and implementing these critical human capital reforms.

Chairman Voinovich, Senator Akaka, and Members of the Subcommittee, this completes my prepared statement. I would be pleased to respond to any questions that you may have.

Contact and Acknowledgments

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