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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

June 16, 2003

The Honorable Todd R. Platts
Chairman
Subcommittee on Government Efficiency
and Financial Management
Committee on Government Reform
House of Representatives

Subject: *Responses to Posthearing Questions Related to GAO's Testimony on the U.S. Government's Consolidated Financial Statements for Fiscal Year 2002*

Dear Mr. Chairman:

On April 8, 2003, I testified before your subcommittee at a hearing on our report on the U.S. government's consolidated financial statements for fiscal year 2002.¹ This letter responds to questions related to our testimony from you and the Ranking Minority Member and to subsequent questions from the Vice Chairman that you asked us to answer for the record. The questions and my responses follow.

Question from Chairman Platts

1. What is the status of the financial management systems modernization effort, agency by agency?

At a meeting with subcommittee counsel and staff on April 16, we agreed on an approach based primarily on available data sources and an end-of-June time frame for separately providing this information. We will compile a list of the 24 Chief Financial Officers (CFO) Act agencies' core financial systems along with key data related to each system, such as whether it is a commercial off-the-shelf system. We will identify the status of agencies' plans to acquire new core financial systems and whether any mixed financial systems at the agencies are slated to be updated.

¹U.S. General Accounting Office, *Fiscal Year 2002 U.S. Government Financial Statements: Sustained Leadership and Oversight Needed for Effective Implementation of Financial Management Reform*, GAO-03-572T (Washington, D.C.: Apr. 8, 2003). The fiscal year 2002 *Financial Report of the United States Government*, issued by the Department of the Treasury on March 31, 2003, is available through GAO's Web site at www.gao.gov and Treasury's Web site at www.fms.treas.gov/fr/index.html.

Question from Ranking Minority Member Towns

1. The Department of Energy for a number of years had problems estimating its environmental liabilities, which it has since corrected. How did Energy manage to correct its problem, and can these solutions be used at the Department of Defense?

The Department of Energy (DOE) is responsible for management and cleanup of environmental contamination related to the process of producing nuclear weapons. For fiscal year 1998, the DOE Inspector General's (IG) financial audit opinion stated that auditors were unable to satisfy themselves that DOE's recorded environmental liability of \$186 billion was fairly stated because of the following deficiencies:

- DOE lacked adequate documentation to support some cost estimates and cost-estimating methodologies.
- Valid environmental liabilities were not included in the estimate.
- Cost estimates had not been updated through the end of the fiscal year under audit.
- Established cost-estimating guidelines were not consistently applied.

For fiscal year 1999, the DOE IG was able to conclude that DOE's reported \$231 billion environmental liability was fairly stated. According to the DOE IG, DOE's Office of Environmental Management completed corrective actions during fiscal year 1999 that included strengthening internal controls over developing the estimate; assessing individual cost estimates that make up the environmental liability in terms of scope, cost, and schedule; and quantifying the uncertainty of the estimates caused by technical problems and funding shortfalls. To ensure the reliability of future environmental liability estimates and to guide cleanup efforts, DOE developed a program, which it documented in the June 1998 publication *Accelerated Cleanup: Paths to Closure*, based on site-developed, project-by-project forecasts of the scope, schedule, and costs to complete DOE's approximately 350 projects. The objective was to manage the cleanup of 90 percent of contaminated sites by 2006. This program, which had the support of top management, was key to DOE's success.

The Department of Defense (DOD) is responsible for management and cleanup of very diverse types of environmental contamination, including

- closed and open sites where past and current waste disposal practices, leaks, spills, and other activities have created a risk to public health or the environment;
- closed, transferring, and active military ranges where contamination and unexploded ordnance create environmental hazards; and
- cleanup, demilitarization, and disposal of nuclear and non-nuclear weapons systems, chemical weapons, and munitions.

Although the types of cleanup are different, the obstacles to reliable cost estimation are similar to those faced by DOE in fiscal year 1998. For the past few years, the DOD IG has reported that the environmental liability figure reported in DOD's financial statements is not auditable because of problems related to insufficient

guidance, lack of audit trails, use of inconsistent or unvalidated cost-estimating models, and incomplete inventories of sites. We have also cited deficiencies in DOD's reported environmental liabilities as a disclaimer issue in the governmentwide audit reports since fiscal year 1997, and we have issued reports on several kinds of environmental cleanup issues, including training ranges and ongoing operations.²

In its fiscal year 2002 performance and accountability report, DOD management included a discussion of progress being made to address material weaknesses, including environmental liabilities. According to the report, DOD

- has issued improved guidance—for all areas except ongoing operations—that will help its components compile complete, accurate, and fully substantiated environmental liability data;
- is developing and maintaining adequate supporting documentation and audit trails for cost-to-complete estimates for the environmental restoration of more than 30,000 closed contaminated sites on open installations, closed installations, and Base Realignment and Closure sites;
- has validated the cost-estimating models used in the calculation and documentation of environmental liability costs;
- has developed a sound methodology for estimating liabilities associated with nuclear-powered ships and submarines; and
- has completed inventories of all but training ranges and sites with ongoing operations that result in contamination.

DOD has also reviewed *Paths to Closure* and believes that DOE's approach is similar to that used by DOD to estimate and report for the Defense Environmental Restoration Program (DERP). DOD reports site-by-site information in its DERP report to Congress each year and estimates cleanup costs for those sites out to the year 2030. DOD has stated that it has also begun reconciling the DERP reported costs to the financial statement reported costs. Finally, DOD has designated the Deputy Under Secretary of Defense (Installations and Environment) as the focal point for all environmental restoration and cleanup issues except for chemical demilitarization, which is the responsibility of the Under Secretary of Defense (Acquisition, Technology and Logistics).

DOD claims that various components of its environmental cleanup and disposal costs are now auditable. For fiscal year 2003, the DOD IG plans to review the Navy's methodology for estimating liabilities associated with nuclear-powered ships and submarines and also to audit the Army's chemical demilitarization cost estimates.

²U.S. General Accounting Office, *Environmental Liabilities: DOD Training Range Cost Estimates Are Likely Understated*, GAO-01-479 (Washington, D.C.: Apr. 11, 2001), and *Environmental Liabilities: Cleanup Costs from Certain DOD Operations Are Not Being Reported*, GAO-02-117 (Washington, D.C.: Dec. 14, 2001).

1. What are your recommendations to arrest spending on Medicare/Medicaid and Social Security?

As I have testified on numerous occasions before various committees, reducing the relative future burdens of Social Security and health programs is critical to promoting a sustainable budget policy for the longer term.³ While much of the public debate concerning the Social Security and Medicare programs focuses on trust fund balances—that is, on the programs’ solvency—the larger issue concerns program sustainability. Absent reform, the impact of federal health and retirement programs on budget choices will be felt long before projected trust fund insolvency dates when the cash needs of these programs begin to seriously constrain overall budgetary flexibility.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window where today’s relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. Second, we lose the opportunity to reduce the burden of interest payments, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Finally, and most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift.

Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing. In fact, the leading edge of the baby boom generation will become eligible for Social Security in only 5 years. As baby boomers retire and the numbers of those entitled to these retirement benefits grow, the difficulties of reform will be compounded. Accordingly, it remains more important than ever to deal with these issues over the next several years.

Many proposals to control spending, increase revenues, and restructure Social Security and Medicare have been put forth by various commissions, members of Congress, and independent “think tanks.” Although we do not make specific policy recommendations, to assist Congress in its deliberations, we have developed criteria for evaluating Social Security reform proposals and soon will issue criteria for evaluating health care reforms. Our criteria for evaluating Social Security reform proposals aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various

³See, for example, U.S. General Accounting Office, *Medicare: Financial Challenges and Considerations for Reform*, GAO-03-577T (Washington, D.C.: Apr. 10, 2003); *Medicare: Observations on Program Sustainability and Strategies to Control Spending on Any Proposed Drug Benefit*, GAO-03-650T (Washington, D.C.: April 9, 2003); *Social Security: Analysis of Issues and Selected Reform Proposals*, GAO-03-376T (Washington, D.C.: Jan. 15, 2003); *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002).

proposals. The use of these criteria can help facilitate fair consideration and informed debate of reform proposals. The weight that different policymakers may place on different criteria will vary, depending on how they value different attributes.

The proposals we have examined, both in 2002 and earlier, reflect the likelihood that the structural changes required to restore Social Security's long-term viability generally may require some combination of reductions from currently scheduled benefits and revenue increases, and may include the use of some general revenues.⁴ Proposals employ possible benefit reductions within the current program structure, including modifying the benefit formula, raising the retirement age, and reducing cost-of-living adjustments. Revenue increases might take the form of increases in the payroll tax rate and/or wage base, expanding coverage to include the relatively few workers who are still not covered under Social Security, or allowing the trust funds to be invested in potentially higher-yielding securities, such as stocks. Similarly, some proposals rely on general revenue transfers to increase the amount of money going toward the Social Security program. Some proposals include individual accounts that would also involve Social Security benefit reductions and/or revenue increases.

Medicare also faces a long-range, fundamental, and more serious financing problem driven by known demographic trends and projected escalation of health care spending beyond general inflation. As with Social Security, Medicare reform would be done best with considerable lead time to phase in changes and before the changes that are needed become dramatic and disruptive. Given the size of Medicare's financial challenge, it is only realistic to expect that reforms intended to bring down future costs will have to proceed incrementally. We should begin this now, when retirees are still a far smaller proportion of the population than they will be in the future. The sooner we get started, the less difficult the task will be.

We should also remember that the sources of some of Medicare's problems—and its solutions—are outside the program and are universal to all health care payers. Some tax preferences mask the full cost of providing health benefits and can work at cross-purposes to the goal of moderating health care spending. Therefore, it may be important to reexamine the incentives contained in current tax policy and consider potential reforms. Advances in medical technology are also likely to keep raising the price tag of providing care, regardless of the payer. Although technological advances unquestionably provide medical benefits, judging the value of those benefits—and weighing them against the additional costs—is more difficult. Consumers are not as informed about the cost of health care and its quality as they may be about other goods and services. Thus, while the greater use of market forces may help to control cost growth, it will undoubtedly be necessary to employ additional transparency and cost control methods as well. Ultimately, we will need to look at broader health care reforms to balance health care spending with other societal priorities. In doing this, it is important to note the fundamental differences between health care wants, which

⁴See, for example, U.S. General Accounting Office, *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, GAO-03-310 (Washington, D.C.: Jan. 15, 2003), and *Social Security: Evaluating Reform Proposals*, GAO/AIMD/HEHS-00-29 (Washington, D.C., Nov. 4, 1999).

are virtually unlimited; needs, which should be defined and addressed; and overall affordability and sustainability, of which there is a limit.

We are preparing a health care framework that includes a set of principles to help policy makers in their efforts to assess various health financing reform options. This framework will examine health care issues systemwide and identify the interconnections between public programs that finance health care and the private insurance market. The framework can serve as a tool for defining policy goals and ensuring the use of consistent criteria for evaluating changes. By facilitating debate, the framework can encourage acceptance of changes necessary to put us on a path to fiscal sustainability.

For Medicare and Medicaid, the sustainability challenge has three levels—the level of the individual programs, the health care system in which they are embedded, and our long-term federal fiscal challenge. GAO’s long-term budget simulations continue to show that to move into the future with no changes to federal health and retirement programs is to envision a very different role for the federal government. Assuming, for example, that the tax reductions enacted in 2001 do not sunset and discretionary spending keeps pace with the economy, by midcentury federal revenues may not even be adequate to pay Social Security and interest on the federal debt. To obtain budget balance, massive spending cuts, tax increases, or some combination of the two would be necessary. Neither slowing the growth of discretionary spending nor allowing the tax reductions to sunset eliminates the imbalance. In addition, while economic growth would help ease our burden, the projected fiscal gap is too great for us to grow our way out of the problem.

2. What is your recommended course of action to address the true cost of new legislation (for example, veterans’ benefits, prescription drug plans)?

Current budget reporting is not always designed to promote the recognition and explicit consideration of the costs of some policies and programs. For example, the government undertakes a wide range of responsibilities, policies, programs, and activities that may obligate it to future spending or simply create an expectation for such spending. These “fiscal exposures” range from explicit liabilities to implicit promises embedded in current policy or public expectations. The examples you cite of new legislation for veterans’ benefits or prescription drug plans could be viewed as creating new fiscal exposures. We have made the following recommendations⁵ to increase the visibility and transparency of such exposures:

- First, we recommend that OMB report the future estimated costs associated with certain exposures as a new budget concept—“exposure level”—as a notational item in the Program and Financing schedule of the President’s budget. As opposed to cash, the “exposure level” might be reported in present value terms.

⁵U.S. General Accounting Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

Specifying the estimated potential future costs associated with current decisions would promote transparency.

- We also recommend that OMB report annually on fiscal exposures, including a concise list and description of such exposures, cost estimates where possible, and an assessment of methodologies and data used to produce the cost estimates. Explicitly and directly integrating this report with long-range projections and analysis of the budget as a whole would increase its usefulness for assessing the potential implications for long-range fiscal sustainability and flexibility. Legislation proposed by the President could be included if the report were issued as part of the President's budget and thus could help inform and provide long-term context to budget deliberations.

Other entities also can promote transparency and visibility of fiscal exposures by various actions:

- FASAB. Continue to make progress on the accounting and reporting front (e.g., trust funds and social insurance).
- Treasury. Enhance disclosures in the annual governmentwide performance and accountability report.
- GAO. Continue to emphasize the issue in existing reports and testimonies. Comment on any annual fiscal exposures report published by OMB.
- Congress. Consider requiring that discounted present value numbers be considered for major revenue- and spending-related legislative proposals before legislation is enacted.

In addition, we have stated that Congress may wish to consider exploring options for improving the information available on and the attention given to fiscal exposures.⁶ To increase congressional attention to such exposures, Congress could develop budget process mechanisms that prompt more deliberation about fiscal exposures. One type of mechanism that could be used is a point of order. Congress could modify budget rules to provide for a point of order against any proposed legislation that creates new exposures or increases the estimated costs of existing exposures over some specified level. Or, revised rules could provide for a point of order against any proposed legislation that does not include estimates of the potential costs of fiscal exposures created by the legislation. A second type of budget process mechanism that would prompt deliberation of fiscal exposures would be to establish triggers that require some action when the estimated future costs of a given exposure rise above some specified threshold.

3. How are audit results being used to affect budgeting processes for the current and next year, and how should they be used?

Ultimately, the objective is for agencies to generate high-quality data and measure performance in a meaningful way to help inform decision makers during the budget

⁶GAO-03-213.

process when allocating resources and determining the most efficient and effective means of achieving policy objectives. Financial audit results are the beginning point in this process and should be considered along with the results of programmatic audits and performance reviews.

Financial statements are included in the annual performance and accountability reports for the 24 CFO Act agencies. These financial statements, along with the accompanying management analysis and performance reports, can provide a wealth of information regarding agency performance and financial condition that can be considered as budgeting decisions are made. One of the objectives of federal financial management reform legislation is to improve the quality and availability of information for decision makers. The results of agency financial statement audits, including the related identification of any internal control weaknesses, noncompliance, and systems issues, provide the starting point for considering an agency's ability to generate the information necessary to make informed decisions about its efficiency and effectiveness in achieving its mission and goals. For fiscal year 2002, while 21 of the 24 CFO Act agencies received an unqualified opinion on their financial statements, auditors for 19 of the 24 agencies reported that the agencies' systems did not comply substantially with at least one of the three requirements of the Federal Financial Management Improvement Act. This lack of compliance raises questions about the ability of these agencies to generate timely, useful, and reliable information needed for day-to-day management and congressional oversight.

The audited financial statements also provide indications of the quality of certain data included in budget requests and historical information that could be considered during budget deliberations. For example, the Statement of Budgetary Resources in the agency's audited financial statements provides information as to the status and uses of budgetary resources, such as amounts remaining available for obligation as of the end of the fiscal year. Because this information is audited, it provides assurance as to the reliability of these amounts in relation to the financial statements as a whole. In areas such as direct loans and loan guarantees, the accounting used for the financial statements under generally accepted accounting principles closely mirrors the Credit Reform Act requirements used for the budget. This means that errors, weaknesses in the estimation process, or other issues identified during the financial statement audit may also be present in related budget requests.

In addition, the audited financial statements provide information not presented in the budget that could also be considered in the budgeting process. For example, liabilities for the total estimated cost of environmental cleanup and other liabilities, such as those for federal employees' and veterans' benefits, are presented in the financial statements. These amounts should include the entire estimated liability for these programs, rather than the projected cash flows for limited periods included in the budget. Further, the statements present information on social insurance programs, such as Social Security and Medicare, that shows the long-term fiscal challenges associated with these programs that could also be considered in the budget process. While much of this information is included in individual agency financial statements, the presentation of this information in the consolidated financial

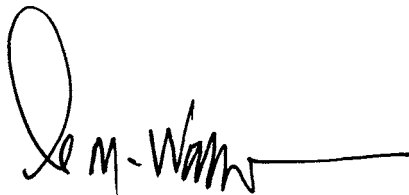
report of the U.S. government can provide a basis for analyzing the overall long-range fiscal challenges faced by our government as a whole, during the deliberative process on the budget.

The audited financial statements present data as of a single point in time or for a specific period. Even if an agency's financial statements received an unqualified opinion, there are no direct assurances about other data from the agency, such as quarterly results or performance information. However, as part of the audits, material weaknesses in internal control and inadequate financial systems are often identified. These deficiencies can affect an agency's ability to generate reliable cost information and measure the performance of its programs. The impact of these conditions on the reliability of other, unaudited agency data should be considered from an oversight or budget perspective.

I am providing copies of this letter to the Ranking Minority Member and Vice Chairman of your subcommittee. This letter is also available on GAO's Web site at www.gao.gov.

If you or your staff have questions about the responses to your questions, please contact me at (202) 512-5500 or Gary T. Engel, Director, at (202) 512-3406 or engelg@gao.gov.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States