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Comptroller General of the United States

United States General Accounting Office
Washington, DC 20548

March 31, 2003

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

Our report on the U.S. government's consolidated financial statements for the fiscal years 2002 and 2001 is enclosed. As in the 5 previous fiscal years, we were unable to express an opinion on the consolidated financial statements because of certain material weaknesses in internal control and in accounting and reporting. These conditions prevented us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements are fairly stated in conformity with U.S. generally accepted accounting principles.

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

Across government, financial management improvement initiatives are under way that, if effectively implemented, have the potential to appreciably improve the quality of the federal government's financial management and reporting. A number of federal agencies have started to make progress in their efforts to modernize their financial management systems and improve financial management performance as called for in the President's Management Agenda. For example, the Department of the Treasury's Internal Revenue Service (IRS) has made significant progress in addressing its financial management weaknesses, including addressing controls over budgetary activity and its accountability over property and equipment. Resolving many of IRS's most serious financial management weaknesses—identified by GAO as a high-risk area since 1995—will require a sustained, long-term commitment of resources, continued strong involvement of senior management, and sustained progress in systems modernization.

This year marks the earliest that federal agencies' audited financial statements have ever been available. For the first time, CFO Act agencies were required to combine their audited financial statements with performance reports and deliver both to the Office of Management and Budget (OMB) by February 1, a month earlier than last year. Furthermore, the Principals of the Joint Financial Management Improvement Program (JFMIP)[1] have agreed to accelerate the agency financial statement reporting date to November 15 for fiscal year 2004. The Social Security Administration, which has a long-standing record of delivering its audited financial statements well before the mandated deadline, issued its fiscal year 2002 audited financial statements on November 19, 2002. The Department of the Treasury also accelerated its time frame and issued its fiscal year 2002 audited financial statements on November 15, 2002, which was more than 3 months earlier than fiscal year 2001.

For fiscal year 2002, 21 of the 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements, up from 6 agencies for fiscal year 1996. Also, 4 CFO Act agencies showed improvement by receiving unqualified opinions from their auditors this year—the Department of Education, the National Aeronautics and Space Administration, the Federal Emergency Management Agency, and the Department of Agriculture, which received an unqualified audit opinion for the first time. On the other hand, the auditor for the Small Business Administration withdrew its unqualified opinions on the agency's fiscal years 2001 and 2000 financial statements and disclaimed its opinions on the agency's fiscal years 2002 and 2001 financial statements.

In identifying improved financial performance as one of its five governmentwide initiatives, the President's Management Agenda stated that a clean (unqualified) financial audit opinion is a basic prescription for any well-managed organization. It recognized that "most federal agencies that obtain clean audits only do so after making extraordinary, labor-intensive assaults on financial records." Further, the President's Management Agenda stated that without sound internal control and accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people.

Building on the success that has been achieved in obtaining unqualified audit opinions, federal agency management must continue to work toward fully resolving the pervasive and generally long-standing material weaknesses that have been reported for the past 6

[1]JFMIP is a joint and cooperative undertaking of the Department of the Treasury, GAO, OMB, and the Office of Personnel Management working in cooperation with each other and other federal agencies to improve financial management practices in the federal government. Leadership and program guidance are provided by the four Principals of the JFMIP—the Comptroller General of the United States, the Secretary of the Treasury, and the Directors of OMB and the Office of Personnel Management.

fiscal years. The underlying causes of these issues are significant financial management systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control. Many federal agencies have continued to expend significant resources to use extensive ad hoc procedures and to make billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. Timely, accurate, and useful financial information is essential for making operating decisions day to day, managing the federal government's operations more efficiently and effectively, meeting the goals of federal financial management reform legislation (such as the CFO Act), supporting results-oriented management approaches, and ensuring accountability on an ongoing basis.

The JFMIP Principals have defined certain measures, in addition to receiving an unqualified financial statement opinion, for achieving financial management success. These additional measures include being able to routinely provide timely, accurate, and useful financial information and having no material internal control weaknesses or material noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). Reports of inspectors general and their contract auditors indicated that only 4 of the 24 CFO Act agencies had neither a material internal control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with FFMIA requirements. While the severity and magnitude of the problems identified varied greatly, auditors for 17 of the 24 CFO Act agencies reported at least one material control weakness. In addition, reports of the inspectors general and their contract auditors indicated that financial management systems of 19 of the 24 CFO Act agencies did not comply substantially with one or more of FFMIA's three federal financial management systems requirements.[2] For the remaining 5 CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating that these agencies' financial management systems did not substantially meet FFMIA requirements. The auditors for these 5 agencies did not definitively state whether these agencies' systems substantially complied with FFMIA requirements, as is required under the statute.

Essential to achieving an opinion on the consolidated financial statements is resolution of the serious financial management problems at the Department of Defense (DOD), which we have designated as high risk since 1995. Overhauling DOD's financial management operations represents a challenge that goes far beyond financial accounting to the very fiber of DOD's range of business operations and culture. DOD's financial management problems are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or

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[2]FFMIA requires auditors, as part of CFO Act agencies' financial statement audits, to report whether agencies' financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards (U.S. generally accepted accounting principles), and the federal government's Standard General Ledger at the transaction level.

major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls. In September 2001, Secretary of Defense Rumsfeld announced a broad, top-priority initiative to transform the full range of the department's business processes, including decades-old financial systems that are not well interconnected. The Secretary of Defense recently included improving DOD's financial management as one of his top 10 priorities, and DOD has already taken a number of actions intended to address its serious financial management problems. In addition, DOD has a major effort under way to develop a DOD enterprise architecture that is intended to prescribe a blueprint for operational and technological changes in its financial and related business systems operations. While DOD has a long way to go, its efforts over the past year represent important progress. The level of top leadership that has been brought to bear on this challenge will have to be sustained with a goal of achieving lasting improvement that truly transforms DOD's business systems and operations and enables the department to meet the mandate of the CFO Act and achieve the President's Management Agenda's goal of improved financial performance.

Two other major impediments to an opinion on the consolidated financial statements are the federal government's inability to (1) account for billions of dollars of transactions between federal government entities and (2) properly prepare the consolidated financial statements. As we reported last year, the heart of the intragovernmental transactions issue is that the federal government lacked clearly articulated business rules for these transactions so that they would be handled consistently by agencies. Compounding this problem, a substantial number of the CFO Act agencies did not fully perform reconciliations of intragovernmental activity and balances with their trading partners.[3] To address this issue, OMB has established standard business rules for certain governmentwide transactions between federal government entities and is requiring quarterly reconciliations of intragovernmental activity and balances beginning in fiscal year 2003. For example, in accordance with one of the business rules, beginning in fiscal year 2003 for intragovernmental investments with Treasury's Bureau of the Public Debt (BPD), BPD and trading partner agencies are required to use the same method for recording amortization on market-based notes, bonds, and zero coupon securities. In the past, differences in the amortization methods being used caused out of balance conditions for related intragovernmental activity and balances.

With respect to properly preparing the consolidated financial statements, Treasury is currently developing a new system and procedures to be used beginning with fiscal year 2004. Treasury's initiative is intended to, among other things, directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements. The continued strong leadership of both OMB and Treasury will be important to resolve the intragovernmental transactions issue and issues surrounding preparing the consolidated financial statements.

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

As previously discussed, the President's Management Agenda includes improved financial performance as one of the top five governmentwide management goals. Other governmentwide initiatives of the President's Management Agenda include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration. These initiatives cannot be addressed in an isolated or piecemeal fashion, but rather must be addressed together along with other major management challenges and high-risk areas in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies. The administration has used the Executive Branch Management Scorecard, which includes broad standards, to highlight federal agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda. This is a step in the right direction to improving management and performance. The value of the scorecard is not in the scoring per se, but in the degree to which scores lead to sustained focus and demonstrable improvements. It will be important that there be continuous rigor in the scoring process in order for this approach to be credible and effective in providing the proper incentives that produce lasting results.

During fiscal year 2002, JFMIP Principals continued the series of regular, deliberative meetings that began in August 2001. We focused on key financial management reform issues such as better defining measures for financial management success, requiring accelerated financial statement reporting across government, enhancing the independence of the Federal Accounting Standards Advisory Board, establishing audit advisory committees for the federal government as a whole and for selected major federal agencies, and addressing difficult accounting and reporting issues. Although many actions have been taken, the continued leadership and personal commitment of the Principals is necessary to continue the momentum for improving the federal government's financial management and performance. At the end of fiscal year 2002, I ended my 2-year term as Chair of the JFMIP Principals, and the Chair rotated to Office of Management and Budget Director Daniels. I look forward to working with the new Chair, Treasury Secretary Snow, and Office of Personnel Management Director James in the upcoming months to continue this important dialogue and build on the strong working relationships that we have established.

As we look ahead, the federal government faces an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. In fact, in 2008—only 5 years from now—the first wave of baby boomers becomes eligible to claim Social Security benefits. As the share of the population over 65 years old climbs to more than 20 percent in 2035, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Absent substantive reform of these entitlement programs, a rapid escalation of federal spending for Social Security, Medicare, and Medicaid is virtually certain to overwhelm the rest of the federal budget.

On March 17, 2003, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees report that the fundamentals of the financial status of both Social Security and Medicare remain highly problematic. However, they stated that Medicare faces financial difficulties that are more severe than those confronting Social Security because costs of the Medicare program are projected to rise faster than costs of the Social Security program. The projections show a 20 percent increase over the prior year in the Present Value of Resources Needed Over the 75-Year Projection Period for Federal Hospital Insurance (Medicare Part A), while the Social Security projection showed an 8 percent increase. Once again, the Trustees state that action to address the financial difficulties facing Social Security and Medicare must be taken in a timely manner and that the sooner these financial challenges are addressed, the more varied and less disruptive the solutions can be.

These long-term demographic and fiscal pressures and the new commitments and actions undertaken as a result of the tragic events of September 11, 2001, serve to increase the need to look at competing claims and new priorities. While reforming health and retirement entitlement programs is essential to preserving fiscal flexibility in the long term, a fundamental review of major programs, policies, and operations can create much-needed fiscal flexibility to address emerging needs. There is a need to consider what the proper role of the federal government will be in the 21st century and how the government should do business in the future.

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

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

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

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

David M. Walker
Comptroller General
of the United States

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Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

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

The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required annually to submit financial statements for the U.S. government to the President and the Congress. GAO is required to audit these statements.[1] This is our report on the accompanying U.S. government's consolidated financial statements for the fiscal years ended September 30, 2002 and 2001,[2] and associated reports on internal control and compliance with laws and regulations.

The federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act are met,[3] and (3) complying with applicable laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies[4] are responsible for implementing and maintaining financial management systems that comply with the Federal Financial Management Improvement Act of 1996 (FFMIA) requirements. Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2002 and 2001. Appendix I discusses the scope and methodology of our work.

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[1] The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331 (e). The federal government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.

[2] The consolidated financial statements for the fiscal years ended September 30, 2002 and 2001, consist of the Statements of Operations and Changes in Net Position, the Statements of Net Cost, and Balance Sheets, including the related notes to these financial statements. In accordance with Statement of Federal Financial Accounting Standards No. 24, which was adopted in January 2003, these consolidated financial statements also include comparative Reconciliations of Net Operating Cost and Unified Budget Surplus (or Deficit) and Statements of Changes in Cash Balance from Unified Budget and Other Activities.

[3] 31 U. S. C. 3512 (c), (d). This act requires agency heads to evaluate and report annually to the President on the adequacy of their internal controls and accounting systems and on actions to correct significant problems.

[4] The Federal Emergency Management Agency (FEMA), one of the 24 CFO Act agencies, transferred to the new Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA will no longer be required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies. DHS, along with most other executive branch agencies, will be required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002).

A significant number of material weaknesses[5] related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to (1) hamper the federal government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the federal government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the federal government's ability to adequately safeguard significant assets and properly record various transactions. Several of these material weaknesses (referred to hereafter as material deficiencies) resulted in conditions that continued to prevent us from expressing an opinion on the accompanying consolidated financial statements for the fiscal years ended September 30, 2002 and 2001.[6] There may also be additional issues that could affect the consolidated financial statements that have not been identified.

In accordance with the National Defense Authorization Act for fiscal year 2002,[7] the Department of Defense (DOD) reported that for fiscal year 2002 DOD's financial management systems were not able to provide adequate evidence supporting material amounts in its financial statements. DOD asserted that it is unable to comply with applicable financial reporting requirements for (1) property, plant, and equipment, (2) inventory and operating materials and supplies, (3) military retirement health care actuarial liability, (4) environmental liabilities, (5) intragovernmental eliminations and related accounting adjustments, and (6) cost accounting by suborganization/responsibility segment and major program.

Based largely on DOD's assertion, the DOD Inspector General disclaimed an opinion on DOD's financial statements for fiscal year 2002 as it had for the previous 6 fiscal years. DOD's financial management systems and reporting weaknesses substantially impair our ability to determine the reliability of the financial information reported in the federal government's overall financial reports. Given the significance of DOD's activities and balances to the consolidated financial statements, until DOD corrects these material weaknesses, they will continue to impede our ability to express an opinion on the consolidated financial statements. In addition, as noted later in this report, there are other material weaknesses that need to be corrected.

DISCLAIMER OF OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

Because we were unable to determine the reliability of significant portions of the accompanying fiscal years 2002 and 2001 U.S. government's consolidated financial statements, we are unable to, and we do not, express an opinion on such financial statements.

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[5] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

[6] We previously reported that material deficiencies prevented us from expressing an opinion on the fiscal years 1997, 1998, 1999, and 2000 consolidated financial statements.

[7] Section 1008, Pub. L. No. 107-107, 115 Stat. 1012 (Dec. 28, 2001).

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

We have not audited and do not express an opinion on the Management's Discussion and Analysis, Stewardship Information, Supplemental Information, or other information included in the accompanying fiscal year 2002 *Financial Report of the United States Government*.

Material Deficiencies

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

Property, Plant, and Equipment and Inventories and Related Property The federal government could not satisfactorily determine that all such assets were included in the consolidated financial statements, verify that certain reported assets actually exist, or substantiate the amounts at which they were valued. A significant portion of the property, plant, and equipment and the vast majority of inventories and related property are the responsibility of DOD. DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to property, plant, and equipment.

Liabilities and Commitments and Contingencies The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, the federal government was not able to reliably estimate key components of DOD's environmental and disposal liabilities and could not support its estimate of military postretirement health benefits liabilities included in federal employee and veteran benefits payable. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other agreements entered into to further the U.S. government's interest, were complete and properly reported.

Cost of Government Operations and Disbursement Activity The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of government operations, most notably related to DOD. As it relates to disbursement reconciliations, some federal agencies did not adequately reconcile disbursements to the Department of the Treasury's (Treasury) records of disbursements, which is intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner. We have seen progress in this area over the past 6 years. However, for fiscal years 2002 and 2001 there were unsupported adjustments and unreconciled differences between federal agencies' and Treasury's records of disbursements totaling billions of dollars.

<u>Accounting for and Reconciliation of Intragovernmental Activity and Balances</u> OMB and Treasury require CFO Act agencies to reconcile selected intragovernmental activity and balances with their "trading partners"[8] 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 GAO. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for fiscal years 2002 and 2001, citing reasons such as (1) trading partners not providing needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resource issues. For both of these years, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, significant differences in other intragovernmental accounts, primarily related to appropriations, will need to be resolved.

To address certain issues that contributed to the out of balance condition for intragovernmental activity and balances, OMB has established a set of standard business rules for governmentwide transactions among trading partners and is requiring quarterly reconciliations of intragovernmental activity and balances beginning in fiscal year 2003. For example, in accordance with one of the business rules, beginning in fiscal year 2003 for intragovernmental investments with Treasury's Bureau of the Public Debt (BPD), BPD and trading partner agencies are required to use the same method for recording amortization on market-based notes, bonds, and zero coupon securities. In the past, differences in the amortization methods being used have caused out of balance conditions for related intragovernmental activity and balances. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by the CFO Act agencies and continued strong leadership by OMB.

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

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

Consolidated Financial Statement Compilation Due to the current financial statement compilation process, the federal government could not adequately ensure that the information for each federal agency included in the consolidated financial statements was consistent with the underlying agency financial statements. This process also requires significant human and financial resources and does not adequately leverage the existing work and work products resulting from federal agencies' audited financial statements. The problems are further compounded by the need for broad changes in the structure of the government's Standard General Ledger (SGL) accounts and the process for maintaining the SGL.

The net position reported in the consolidated financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. To make the fiscal years 2002 and 2001 consolidated financial statements balance, Treasury recorded a net $17.1 billion and $17.3 billion decrease to net operating cost, respectively, on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions.[9] An additional net $12.5 billion and $3.9 billion of unreconciled transactions were improperly recorded in net cost for fiscal years 2002 and 2001, respectively. Treasury attributes these net unreconciled transaction amounts primarily to the federal government's inability to properly identify and eliminate transactions between governmental entities, federal agency adjustments that affected net position, and other errors. Treasury was unable to adequately identify and explain the gross components of such amounts. Unreconciled transactions also may exist because the federal government does not have effective controls over reconciling net position.

The federal government did not have an adequate process to reconcile the operating results, which for fiscal year 2002 showed a net operating cost of $364.9 billion, to the budget results, which for the same period showed a unified budget deficit of $157.7 billion.

Treasury is currently developing a new system and procedures to prepare the consolidated financial statements beginning with fiscal year 2004. These actions are intended to, among other things, directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements and facilitate the reconciliation of net position.

Elimination of Intragovernmental Activity and Balances Consolidated financial statements are intended to present the results of operations and financial position of the components that make up a reporting entity as if the entity were a single enterprise. When preparing the consolidated financial statements, the preparer must eliminate intragovernmental activity and balances between the federal

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[9] Prior to fiscal year 2001, the federal government reported unreconciled transactions as a change in net position. Although the federal government was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the accompanying consolidated financial statements.

agencies. Because of federal agencies' problems in handling their intragovernmental transactions, Treasury's ability to eliminate these transactions is impaired. Significant differences reported in intragovernmental accounts, as noted above, have been identified. To help federal agencies better perform their reconciliations, Treasury recently began providing agencies with detailed trading partner information. Intragovernmental activity and balances are "dropped" or "offset" in the preparation of the consolidated financial statements rather than eliminated through balanced accounting entries. This contributes to the federal government's inability to determine the impact of these differences on amounts reported in the consolidated financial statements.

OPINION ON INTERNAL CONTROL

In addition to the material weaknesses noted above, we found four other material weaknesses in internal control as of September 30, 2002, which are described below. Because of the effects of the material weaknesses discussed in this report, in our opinion, the federal government did not maintain effective internal control to meet the following objectives: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and stewardship information in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and stewardship information. Individual federal agency financial statement audit reports identify additional reportable conditions[10] in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These matters do not represent material weaknesses at the governmentwide level. Also, due to the issues noted throughout this report, additional material weaknesses may exist that have not been reported.

Loans Receivable and Loan Guarantee Liabilities Prior to fiscal year 2001, we cited accounting for loans receivable and loan guarantee liabilities as a material deficiency contributing to our disclaimer because certain key federal credit agencies could not reliably estimate the costs of their lending programs or determine the net loan amounts expected to be collected. In fiscal year 2001, due to significant improvements at the Department of Agriculture, we removed this area from the list of issues contributing to our disclaimer. Nevertheless, several federal agencies continue to have significant deficiencies in the processes and procedures used to estimate the costs of their lending programs and value their loan receivables. For example, the auditor for the Small Business Administration (SBA) withdrew its unqualified opinions on the agency's fiscal years 2001 and 2000 financial statements because SBA lacks reliable financial data to assess the overall financial impact of its loan asset sales and is unable to support its net

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

loans receivable balance. This raises significant concerns about SBA's ability to reasonably estimate its loan program costs for budget and financial statement purposes.[11] In addition, we again noted that other federal credit agencies continue to require significant adjustments to the estimates of program costs, net loan amounts to be collected, and related notes. Auditors for these agencies reported related material internal control weaknesses.

Improper Payments Across the federal government, improper payments occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds.[12] Many improper payments occur in federal programs that are administered by entities other than the federal government. In general, improper payments often result from a lack of or an inadequate system of internal controls. Most federal agencies have not estimated or reported the magnitude of improper payments in their programs, and while estimates of improper payments disclosed in federal agency financial statements totaled about $20 billion for both fiscal years 2002 and 2001,[13] the federal government did not estimate the full extent of improper payments. The President's Management Agenda includes addressing erroneous payments (a term we consider synonymous with improper payments) as one of the key elements for improving financial performance. Accordingly, OMB, which has shown leadership in this area, now requires annual submissions on improper payments from 15 federal agencies. Specifically, OMB requires actual and projected information on erroneous payment rates and the status of actions taken to reduce improper payments. Further, the Improper Payments Information Act of 2002[14] requires federal agencies to (1) annually review programs and activities that they administer to identify those that may be susceptible to significant improper payments, (2) estimate improper payments in susceptible programs and activities, and (3) provide reports to Congress that include the status of actions to reduce improper payments for programs and activities with estimated improper payments of $10 million or more.

Information Security GAO has reported information security over computerized operations as a governmentwide high-risk area since February 1997.[15] Information

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[11]U.S. General Accounting Office, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: January 2003).
[12]Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.
[13]In trying to establish a baseline of erroneous payments, OMB's fiscal year 2001 estimate of more than $30 billion, reported in Management's Discussion and Analysis, includes amounts from agency sources other than published financial statements. For purposes of this report, we considered only those amounts published in agency fiscal years 2001 and 2002 performance and accountability reports, which include financial statements. We acknowledge that until all agencies systematically identify and report improper payments using the same method of reporting, as required by the Improper Payments Information Act of 2002, there may be variances between the amounts reported annually by OMB and GAO.
[14]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).
[15]See, for example, U.S. General Accounting Office, *High-Risk Series: Protecting Information Systems Supporting the Federal Government and the Nation's Critical Infrastructures,* GAO-03-121 (Washington, D.C.: January 2003).

security weaknesses are placing enormous amounts of federal government assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. The federal government is not in a position to estimate the full magnitude of actual damage and loss resulting from federal information security weaknesses because it is likely that many such incidents are either not detected or not reported. Although progress has been made, federal agencies have not yet institutionalized comprehensive security management programs, which are critical to resolving information security problems and managing information security risks on an ongoing basis. To provide a comprehensive framework for ensuring the effectiveness of information security controls, the Federal Information Security Management Act of 2002[16] was enacted in December 2002.

Tax Collection Activities Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities.[17] Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS

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

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

AGENCY FINANCIAL MANAGEMENT SYSTEMS

To achieve the financial management improvements envisioned by the CFO Act, FFMIA, and, more recently, the President's Management Agenda, federal agencies need to modernize their financial management systems to generate reliable, useful, and timely financial information throughout the year and at year-end. As discussed throughout this report, financial management systems weaknesses have contributed to our inability to determine the reliability of the consolidated financial statements. FFMIA requires

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[16] Pub. L. No. 107-347, Title III, 116 Stat. 2946 (Dec. 17, 2002).
[17] U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements,* GAO-03-243 (Washington, D.C.: Nov. 15, 2002).

auditors, as part of CFO Act agencies' financial statement audits, to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards (U.S. generally accepted accounting principles), and (3) the federal government's SGL at the transaction level. For fiscal year 2002, auditors for 19 CFO Act agencies reported that the agencies' financial management systems did not comply substantially with one or more of these three FFMIA requirements. Meeting the requirements of FFMIA has presented long-standing, significant challenges. These challenges will be resolved only through time, investment, and sustained emphasis on correcting deficiencies in federal financial management systems. GAO plans to report to the Congress by October 1, 2003, on CFO Act agencies' FFMIA implementation for fiscal year 2002, as required by the act.

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

David M. Walker
Comptroller General
of the United States

March 20, 2003

APPENDIX I

SCOPE AND METHODOLOGY

The Government Management Reform Act of 1994 expanded the requirements of the CFO Act by making the inspectors general of 24 major federal agencies responsible for annual audits of agencywide financial statements prepared by these agencies and GAO responsible for the audit of the U.S. government's consolidated financial statements.[18] Our work was performed in coordination and cooperation with the inspectors general to achieve our joint audit objectives. This work included separate GAO audits of certain significant federal agency components, as discussed below. Our audit approach focused primarily on determining the current status of the material deficiencies and the other material weaknesses affecting internal control that we had previously reported in our report on the consolidated financial statements for fiscal year 2001.[19] We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and the results of our assessment of compliance with applicable laws and regulations.

We separately audited the following significant federal agency components.

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2002 and 2001 financial statements, which included approximately $2 trillion and $2.1 trillion of tax revenue and $281 billion and $251 billion of tax refunds for fiscal years 2002 and 2001, respectively, and $20 billion of net federal taxes receivable each year.[20] In fiscal year 2002, we continued to report numerous material internal control weaknesses, which resulted in ineffective internal controls. We also reported two instances of noncompliance with applicable laws and regulations and lack of substantial compliance of IRS's financial management systems with FFMIA.

- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2002 and 2001.[21] The schedules reported for these 2 fiscal years (1) approximately $3.6 trillion (2002) and $3.3 trillion (2001) of federal debt held by the public comprising individuals, corporations, state and local governments, the Federal Reserve Banks, and foreign governments and central banks, (2) about $2.7 trillion (2002) and $2.5 trillion (2001) of intragovernmental debt holdings, which represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds, and (3) nearly $172 billion (2002)

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

[19] For our report on the U.S. government's consolidated financial statements for fiscal year 2001, see U.S. Department of the Treasury, *Financial Report of the United States Government* (Washington, D.C.: March 2002), pp. 25-42, which can be found on GAO's Internet site at www.gao.gov.

[20] GAO-03-243.

[21] U.S. General Accounting Office, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2002 and 2001 Schedules of Federal Debt*, GAO-03-199 (Washington, D.C.: Nov. 1, 2002).

and $207 billion (2001) of interest on federal debt held by the public.[22] We reported that as of September 30, 2002, BPD had effective internal control over financial reporting and compliance with laws and regulations related to the Schedule of Federal Debt. Further, we reported that there was no reportable noncompliance in fiscal year 2002 with laws we tested.

- We audited and expressed unqualified opinions on the December 31, 2001 and 2000, financial statements of the funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund.[23] We reported that as of December 31, 2001, FDIC had effective internal control over financial reporting and compliance with laws and regulations. In addition, we performed audit procedures and tests of internal control over certain material balances of the funds administered by FDIC as of September 30, 2002.

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

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[22]On June 28, 2002, legislation was enacted to raise the statutory debt limit by $450 billion to $6.4 trillion. On February 20, 2003, the Secretary of the Treasury began exercising statutory authority available to him to avoid exceeding the current $6.4 trillion debt ceiling. As of March 20, 2003, the debt ceiling had not been raised.

[23]U.S. General Accounting Office, *Financial Audit: Federal Deposit Insurance Corporation's 2001 and 2000 Financial Statements*, GAO-02-633 (Washington, D.C.: May 21, 2002).

APPENDIX II

Primary Effects Caused by the Material Weaknesses Described in This Report

Areas Involving Material Weaknesses	Primary Effects on the Fiscal Years 2002 and 2001 Consolidated Financial Statements and the Management of Government Operations
Property, plant, and equipment and inventories and related property	Without accurate asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss, (2) account for acquisitions and disposals of such assets, (3) ensure the assets are available for use when needed, (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (5) determine the full costs of programs that use these assets.
Liabilities	Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government's ability to determine priorities for cleanup and disposal activities and to allow for appropriate consideration of future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.
Cost of government operations and disbursement activity	Inaccurate cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.
Accounting for and reconciliation of intragovernmental activity and balances	Problems in accounting for and reconciling intragovernmental activity and balances impair the government's ability to account for billions of dollars of transactions between governmental entities.
Preparation of consolidated financial statements	Weaknesses related to the preparation of the consolidated financial statements impair the federal government's ability to (1) fully ensure that the consolidated financial statements were consistent with federal agency financial statements and were properly balanced and (2) adequately reconcile the operating results reported in the consolidated financial statements with the unified budget results.
Improper payments	Without a systematic measurement of the extent of improper payments, federal agency management cannot determine (1) if improper payment problems exist that require corrective action, (2) mitigation strategies and the appropriate amount of investments to reduce them, and (3) the success of efforts implemented to reduce improper payments.
Loans receivable and loan guarantee liabilities	Weaknesses in the processes and procedures for estimating credit program costs affect the government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.
Information security weaknesses	Information security weaknesses over computerized operations are placing enormous amounts of federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption.
Tax collection activities	Weaknesses in controls over tax collection activities continue to affect the federal government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting affect the federal government's ability to make informed decisions about collection efforts. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

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