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**Comptroller General  
of the United States**  
**Washington, D.C. 20548**

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B-282041

March 31, 1999

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

Implementation of important legislative reforms is underway to promote greater accountability in managing the finances of our national government. These reforms include requirements for annual audited financial statements for 24 major departments and agencies as well as preparation of the financial statements of the U.S. government, which GAO is required to audit. The report on our audit of these financial statements for fiscal year 1998 is enclosed.

These financial reporting requirements are prompting steady improvements in federal financial accountability, and there has been progress toward meeting the related legislative objectives. At the same time, several major departments are not yet able to produce auditable financial statements on a consistent basis. There are major obstacles to overcome, both at the agency level and in preparing reliable financial statements for the U.S. government.

The executive branch recognizes the extent and severity of the financial management deficiencies and that addressing them will require concerted improvement efforts across government. The administration has set goals for completing timely audits and receiving unqualified opinions for individual agencies as well as the financial state-

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ments of the U.S. government. With a concerted effort, the federal government, as a whole, can continue to make progress toward achieving accountability and generating reliable financial and management information on a regular basis. Annual financial audits represent an important means to assure continued progress in connection with improving federal financial management.

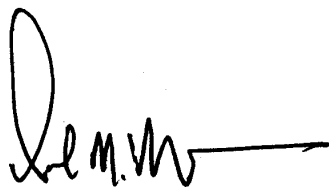
While obtaining unqualified “clean” audit opinions on federal financial statements is an important objective, it is not an end in and of itself. The key is to take steps to continuously improve internal controls and underlying financial and management information systems as a means to assure accountability, increase the economy, improve the efficiency, and enhance the effectiveness of government. These systems must generate timely, accurate, and useful information on an ongoing basis, not just as of the end of the fiscal year.

Reliable financial information is essential for analyzing the government’s financial condition and helping inform budget deliberations by providing additional information beyond that provided in the budget. The budget of the federal government is primarily formulated on a cash basis which also is generally the basis for calculating the annual budget surplus or deficit. The financial statements are prepared generally on the accrual basis of accounting. The most significant difference is the timing of recognition and measurement of revenues and costs. Accrual information can be used with budgetary information to provide a valuable perspective on the costs of agency programs and the government’s assets and long-term commitments.

We appreciate the cooperation and assistance we received from the Chief Financial Officers and Inspectors General throughout government, as well as Department of Treasury and Office of Management and Budget officials, in carrying out our responsibility to audit the government’s financial statements. We look forward to continuing to work with these officials and the Congress to achieve the goals and objectives associated with financial management reform.

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Our report was prepared under the direction of Gene L. Dodaro, Assistant Comptroller General, and Robert F. Dacey, Director, Consolidated Audit and Computer Security Issues. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-3317.

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David M. Walker  
Comptroller General  
of the United States

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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 to annually submit financial statements for the U.S. Government to the President and the Congress.<sup>1</sup> GAO is required to audit these statements. This is our report on our audit of the financial statements of the U.S. government for fiscal year 1998.<sup>2</sup>

In summary, significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. These deficiencies affect the reliability of the accompanying financial statements and much of the related information in the 1998 Financial Report of the United States Government, as well as the underlying financial information. They also affect the government's ability to accurately measure the full cost and financial performance of programs and manage its operations. Major problems included the federal government's inability to:

- properly account for and report (1) billions of dollars of property, equipment, materials, and supplies and (2) certain stewardship assets;

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<sup>1</sup> The Government Management Reform Act of 1994 requires such reporting beginning with financial statements prepared for fiscal year 1997.

<sup>2</sup> Our report on the fiscal year 1997 financial statements is entitled Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

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- properly estimate the cost of most major federal credit programs and the related loans receivable and loan guarantee liabilities;
- estimate and reliably report material amounts of environmental and disposal liabilities and related costs;
- determine the proper amount of various reported liabilities, including postretirement health benefits for military employees, accounts payable, and other liabilities;
- accurately report major portions of the net cost of government operations;
- determine the full extent of improper payments that occur in major programs and that are estimated to involve billions of dollars annually;
- ensure that all disbursements are properly recorded; and
- properly prepare the federal government's financial statements, including balancing the statements, accounting for billions of dollars of transactions between governmental entities, and properly and consistently compiling the information in the financial statements.

Such deficiencies prevented us from being able to form an opinion on the reliability of the accompanying financial statements. These deficiencies significantly impair the federal government's ability to adequately safeguard assets, properly record transactions, and comply with selected provisions of laws and regulations related to financial reporting. Additionally, (1) serious computer security weaknesses expose the government's financial and other sensitive information to inappropriate disclosure, destruction, modification, and fraud, and critical operations to disruption and (2) material control weaknesses affect the government's tax collection activities. Further, tests for compliance with selected provisions of laws and regulations related to financial reporting disclosed material instances of noncompliance discussed later in this report. Also, the financial management systems of almost all agencies were found not to be in compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

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Our audit and the Inspectors General (IG) audits of major component agencies' financial statements for fiscal year 1998 continue to result in (1) an identification and analysis of deficiencies in the government's recordkeeping, financial reporting, and control systems and (2) recommendations to correct them. Fixing these problems represents a significant challenge because of the size and complexity of the government and the discipline needed to follow sound financial management and reporting practices.

In response to our report on the federal government's fiscal year 1997 financial statements, on which we also disclaimed an opinion, the President required heads of agencies with significant financial management deficiencies to submit corrective action plans to OMB. Further, the President has designated financial management reform as a top management priority. Action is underway across government to address the pervasive, generally long-standing problems discussed in this report.

This report provides our (1) disclaimer of opinion on the government's fiscal year 1998 financial statements, (2) report on internal control, and (3) report on compliance with selected provisions of laws and regulations related to financial reporting. It also presents information on the Year 2000 computing challenge and highlights certain long-term financing issues facing government. Our report provides illustrations of the identified material deficiencies. A more complete discussion of these issues may be found in individual agency reports. The objectives, scope, and methodology of our work are discussed in the appendix to this report. We provided a draft of this report to Department of the Treasury and OMB officials, who expressed their commitment to address the deficiencies this report outlines. Our work was done in accordance with generally accepted government auditing standards.

#### DISCLAIMER OF OPINION

Because we were unable to determine the reliability of significant portions of the accompanying financial statements for the reasons described

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above, we are unable to, and we do not, express an opinion on the accompanying financial statements for fiscal year 1998. However, we were able to determine that certain amounts reported for environmental and disposal liabilities are understated by a material amount.

Because of the serious deficiencies in the government's systems, recordkeeping, documentation, financial reporting, and controls, amounts reported in the financial statements and related notes do not provide a reliable source of information for decision-making by the government or the public. These deficiencies also affect the reliability of information contained in the accompanying Management's Discussion and Analysis and any other financial management information—including information used to manage the government day-to-day and certain budget information reported by agencies—which is taken from the same data sources as the financial statements.

Further, while we have not audited and do not express an opinion on the Stewardship Information and Supplemental Information included in the accompanying Financial Report, we noted certain material omissions related to the presentation of national defense assets and issues related to the reconciliation of the results of operations to budget results, which are discussed below.

Also, as discussed in note 14 to the financial statements, the government adopted certain accounting standards in fiscal year 1998, primarily related to reporting national defense assets, which include major weapons systems, as part of Stewardship Information.

#### Material Deficiencies

The following sections describe material deficiencies we identified and discuss their effects on the financial statements and the management of government operations. Each of these deficiencies constitutes a material weakness in internal control.<sup>3</sup>

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<sup>3</sup> A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors, fraud, or noncompliance in amounts that would be material to the financial statements may occur and not be detected on a timely basis by employees in the normal course of performing their duties.



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General Property, Plant, and Equipment and Inventories  
and Related Property

The federal government—one of the world’s largest holders of physical assets—does not have adequate systems and controls to ensure the accuracy of information about the amount of assets held to support its domestic and global operations. A majority of the \$466 billion of these reported assets is not adequately supported by financial and/or logistical records. Assets that are not adequately supported include: (1) buildings, structures, facilities, and equipment, (2) various government-owned assets that are in the hands of private sector contractors, and (3) operating materials and supplies comprised largely of ammunition, defense repairable items (such as navigational computers, landing gear, and transmissions), and other military supplies. Also, the government cannot ensure that all assets are reported. Further, national defense asset unit information reported as Stewardship Information was incomplete because it did not include major national defense support equipment, such as uninstalled engines, and national defense assets held by some military units were not reported.

Because the government lacks complete and reliable information to support its asset holdings, it could not satisfactorily determine that all assets were included in the financial statements, verify that reported assets actually exist, or substantiate the amounts at which they were valued. For example, periodic physical counts have shown that property records contain significant error rates. Further, weak controls significantly impair the government’s ability to detect and investigate fraud or theft of assets. Also, deferred maintenance information was not reported.

Accurate asset information is necessary for the government to (1) know the assets it owns and their location and condition, (2) safeguard its assets from physical deterioration, theft, or loss, (3) account for acquisitions and disposals of such assets, (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (5) determine the full costs of government programs that use these assets.

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### Loans Receivable and Loan Guarantee Liabilities

Most federal credit agencies responsible for federal lending programs were unable to properly estimate the cost of these programs in accordance with federal accounting standards and budgeting requirements. As of the end of fiscal year 1998, the government reported \$167 billion of loans receivable and \$38 billion of liabilities for estimated losses related to estimated future defaults of guaranteed loans. However, the net loan amounts expected to be collected and guarantee amounts expected to be paid could not be reasonably estimated because of a lack of adequate historical data or other evidence. Reliable information about the cost of credit programs is important in supporting annual budget requests for these programs, making future budgetary decisions, managing program costs, and measuring the performance of credit activities. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, small businesses, veterans' mortgages, and student loans.

### Environmental and Disposal Liabilities

Liabilities for remediation of environmental contamination and disposal of hazardous waste, reported at \$225 billion, were materially understated by at least tens of billions of dollars primarily because no estimate was reported for environmental and disposal liabilities associated with certain major weapons systems, such as aircraft, missiles, ships and submarines, and for ammunition. Further, only a small portion of the total cost, estimated to be over \$10 billion, to remove unexploded ordnance from training ranges has been reported. Additionally, significant portions of the government's reported liability for environmental management and legacy waste related to nuclear weapons development lacked adequate support, were not complete, and did not reflect material changes in cleanup scope, costs, or schedules. Properly stating these liabilities and improving internal controls supporting the process for their estimation could assist in determining priorities for cleanup and disposal activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities.

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### Liabilities

Adequate systems and cost data were not available to accurately estimate the reported \$223 billion military postretirement health benefits liability included in federal employee and veteran benefits payable. Information used to develop such estimates did not include the full cost of providing health care benefits. Also, some agencies do not maintain adequate records or have systems to ensure that accurate and complete data were used to estimate a reported \$90 billion of accounts payable and a reported \$155 billion in other liabilities. For example, a liability was not reported for certain amounts owed to contractors that, under the terms of the contracts, were held by the government pending the acceptance of goods or services. Further, the government was unable to provide adequate information to determine whether commitments and contingencies were complete and properly reported. These problems significantly affect the determination of the full cost of the government's current operations, the value of its assets, and the extent of its liabilities.

### Cost of Government Operations

The government was unable to support significant portions of the more than \$1.8 trillion reported as the total net cost of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective cash disbursement reconciliations, as discussed below, affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost categories on the Statement of Net Cost and in the subfunction detail in Supplemental Information were properly classified. Accurate cost information is important to the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required.

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### Improper Payments

The government is unable to determine the full extent of improper payments—that is, payments made for other than valid, authorized purposes. Across government, improper payments occur in a variety of programs and activities, including those related to contract management, federal financial assistance, and tax refunds. Reported estimates of improper payments total billions of dollars annually. Such payments can result from incomplete or inaccurate data used to make payment decisions, insufficient monitoring and oversight, or other deficiencies in agency information systems and weaknesses in internal control. The risk of improper payments is increased in programs involving (1) complex criteria for computing payments, (2) a significant volume of transactions, or (3) an emphasis on expediting payments. The reasons for improper payments range from inadvertent errors to fraud and abuse.

The full extent of improper payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs, nor have they considered this issue in their annual performance plans. The use of appropriate performance measures relating to improper payments can provide management focus on reducing related losses. For example, the Department of Health and Human Services (HHS) has reported a national estimate of improper payments in its Medicare fee-for-service benefits since fiscal year 1996. For fiscal year 1998, the Department reported estimated improper payments of \$12.6 billion, or more than 7 percent, of Medicare fee-for-service benefits—down from about \$20 billion, or 11 percent, reported for fiscal year 1997 and \$23.2 billion, or 14 percent, for fiscal year 1996. Analysis of improper Medicare payments helped lead to the implementation of several initiatives intended to reduce improper payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

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### Cash Disbursement Activity

Several major agencies are not effectively reconciling cash disbursements. These reconciliations are intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner—similar in concept to individuals reconciling personal checkbooks with a bank's records each month. There continued to be billions of dollars of unresolved gross differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1998. As a result, the government is unable to ensure that all disbursements are properly recorded. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by agencies for inclusion in the President's budget concerning fiscal year 1998 obligations and outlays.

### Preparation of Financial Statements

The government does not have sufficient systems, controls, or procedures to properly prepare financial statements for the U.S. government. Such deficiencies, described below, impair the government's ability to (1) properly balance the government's financial statements and account for billions of dollars of transactions between governmental entities, (2) properly and consistently compile the information in the financial statements, and (3) effectively reconcile the results of operations reported in the financial statements with budget results.

*Unreconciled Transactions.* To make the financial statements balance, Treasury recorded a net \$24 billion item on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. Treasury attributes this net out-of-balance amount to the government's inability to properly identify and eliminate transactions between federal government entities and to agency adjustments that affected net position. Certain intragovernmental accounts do not reconcile by a total of more than \$250 billion.

Agencies' accounts can be out of balance with each other, for example, when one or the other of the affected agencies does not properly

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record a transaction with another agency or the agencies record the transactions in different accounting periods. These out-of-balance conditions can be detected and corrected by instituting procedures for reconciling transactions between agencies on a regular basis and in a timely manner. Generally, such reconciliations are not performed. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

*Financial Statement Compilation.* The federal government cannot ensure that the information in the financial statements of the U.S. government is properly and consistently compiled. To prepare the federal government's financial statements, about 70 agencies submit data to Treasury on approximately 2,000 separate reporting components, each having many account balances. However, several major agencies were unable to provide assurance that all agency amounts included in these financial statements reconciled with their agency financial statements. In addition, material adjustments and reclassifications were required to (1) make the financial statements more consistent with agency financial statements, (2) correct identified inconsistencies in reporting similar transactions, (3) conform footnote information to related financial statement line items, and (4) record other audit adjustments.

These problems are compounded by the substantial volume of information submitted and limitations in the federal government's general ledger account structure. As a result, additional misclassifications and misstatements in the government's financial statements could exist.

*Reconciling the Results of Operations With Budget Results.* The federal government did not have a process to obtain information to effectively reconcile the reported \$134 billion excess of net cost over revenue and a reported unified budget surplus of \$69 billion. Consequently, it could not identify all of the items needed to reconcile these amounts. Certain differences are expected to occur because the financial statements of the U.S. government are prepared on the accrual basis in accordance with federal accounting standards, which is a different basis than the budget. Under accrual accounting, transactions are reported when the events giving rise to the transactions occur, rather than when cash is received or paid. By con-

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trast, federal budgetary reporting is generally on the cash basis in accordance with accepted budget concepts and policies.

Beginning in fiscal year 1998, major agencies were required by federal accounting standards to reconcile their reported net costs to budget information, which could provide a basis for preparing the reconciliation in the 1998 Financial Report of the United States Government. However, significant amounts reported in certain agency reconciliations, including unliquidated obligations and certain other budget information, lacked adequate supporting information and may be unreliable. For example, significant weaknesses in Department of Defense (DOD) systems and controls resulted in reported obligations incurred that may have exceeded available budget authority for certain appropriations. Further, significant amounts of Defense transactions were not applied or were incorrectly applied to specific budget appropriations, which could misstate certain reported budget information. Once the federal government produces reliable financial statements, an effective reconciliation could help provide additional assurance of the reliability of budget results.

#### INEFFECTIVE INTERNAL CONTROL

Because of the effects of the material weaknesses discussed below, the federal government has not maintained effective internal control to ensure that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in accordance with federal accounting standards, 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 other laws, regulations, and governmentwide policies identified by OMB Bulletin 98-08.<sup>4</sup> Individual agency financial statement audit reports describe the effects of

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<sup>4</sup> OMB Bulletin 98-08, Audit Requirements for Federal Financial Statements, August 24, 1998, as amended January 25, 1999.

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such weaknesses on specific agencies and identify additional internal control weaknesses, some of which are material to individual agencies.

In addition to the material weaknesses related to the deficiencies discussed in our disclaimer on the financial statements, we found that (1) widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many of the material deficiencies discussed above and (2) material control weaknesses affect the government's tax collection activities. Due to the deficiencies noted throughout this report, additional material weaknesses may exist that have not been reported.

#### Computer Security Weaknesses

Continuing serious and widespread computer security weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant computer security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. Other types of weaknesses pertain to not adequately segregating duties to help ensure that people do not conduct unauthorized actions without detection, preventing unauthorized software from being implemented, and mitigating and recovering from unplanned interruptions in computer service. In today's highly computerized and interconnected environment, such weaknesses are vulnerable to exploitation by outside intruders as well as authorized users with malicious intent.

The consequences of computer security weaknesses could be devastating and costly—for instance, placing billions of dollars of payments and collections at risk of fraud and impairing military operations. Also, identified weaknesses at federal entities such as the Internal Revenue Service (IRS), the HHS's Health Care Financing Administration, the Social Security Administration (SSA), the Department of State, and the Department of Veterans Affairs place tax, medical and other sensitive records at risk of unauthorized disclosure, modification, and destruction.



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The government cannot estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are either not detected or not reported. However, GAO and agency reviews and documented incidents, such as the following, illustrate the potential for negative impacts.

- Attackers have accessed systems and stolen, modified, and destroyed both data and software at DOD and shut down entire systems.
- We have been successful, as part of computer security reviews, in readily gaining unauthorized access to systems that would allow intruders to read, modify, or delete data for whatever purpose they had in mind. Tests by agencies have revealed similar results.
- SSA's IG has reported criminal convictions involving SSA employees, most of which involved creating fictitious identities, fraudulently selling SSA cards, misappropriating refunds, or abusing access to confidential information.
- IRS has identified incidents of employees browsing taxpayer data and inappropriately using other systems containing taxpayer data.

GAO and the IGs have issued numerous reports that identify information security weaknesses in the federal government and made recommendations to address them. Also, GAO has reported information security as a high-risk area across government since February 1997.<sup>5</sup> Agencies need to fully institute a framework for assessing risk and ensuring that necessary policies and controls are in place and remain effective on an ongoing basis.

#### Tax Collection Activities

The federal government continues to have material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue. This situation results in the need for extensive, costly, and time-consuming ad hoc

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<sup>5</sup> High-Risk Series: An Update (GAO/HR-99-1, January 1999), High-Risk Series: An Overview (GAO/HR-97-1, February 1997), and High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

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programming and analysis, as well as material audit adjustments, to prepare basic financial information—an approach that cannot be used to prepare such information on a timely, routine basis to assist in ongoing decision-making. Additionally, the severity of the system deficiencies that give rise to the need to resort to such procedures for financial reporting purposes, as well as deficient physical safeguards, result in burden to taxpayers and lost revenue.

Serious financial management system deficiencies continue to affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.<sup>6</sup> The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness has resulted in the government pursuing collection efforts against individual taxpayers who had already paid their taxes in full. The federal government also continues to be vulnerable to loss of tax revenue due to weaknesses in preventive controls over disbursements for tax refunds. The government does not perform sufficient up-front verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Additionally, delays in recording tax amounts owed result in lost opportunities to retain or offset overpayments made by a taxpayer for one period to collect on outstanding amounts owed for another period, resulting in lost revenue. Finally, serious deficiencies in physical controls over cash, checks, and sensitive data received from taxpayers increase both the government's and the taxpayers' exposure to losses and increases the risk of taxpayers becoming victims of crimes committed through identity fraud.

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<sup>6</sup> Other unpaid assessments consist of amounts for which (1) neither the taxpayer nor a court has affirmed are owed or (2) the government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency.

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NONCOMPLIANCE WITH  
CERTAIN LAWS AND REGULATIONS

Our objective was not to, and we do not, express an opinion on overall compliance with laws and regulations. Tests for compliance with selected provisions of laws and regulations related to financial reporting disclosed that, as discussed earlier, the federal government makes improper payments in major programs such as Medicare. Additionally, as described below, we noted that federal systems do not substantially comply with federal financial management systems requirements. We caution that noncompliance other than that discussed in our report may occur and not be detected by these tests and that our limited testing may not be sufficient for other purposes. Further, the scope of our tests was limited by the material deficiencies discussed above. Other instances of noncompliance, some of which are material to individual federal agencies, are reported in the individual agency financial statement audit reports.

Noncompliance with the Federal Financial Management Improvement Act of 1996

The Federal Financial Management Improvement Act (FFMIA) of 1996 requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. For fiscal year 1997, agency financial auditors reported that 20 of 24 major agencies' financial systems did not comply with the Act's requirements. Similar results are expected for fiscal year 1998. Noncompliance with FFMIA, which we further discuss in our report, Financial Management: Federal Financial Management Improvement Act Results for Fiscal Year 1997 (GAO/AIMD-98-268, September 30, 1998), is indicative of the overall continuing poor condition of agency financial systems.

The majority of federal agencies' financial management systems do not meet systems requirements and cannot provide reliable financial information for managing day-to-day government operations and holding manag-

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ers accountable. For many agencies, the preparation of financial statements requires considerable reliance on ad hoc programming and analysis of data produced by inadequate financial systems that are not integrated, reconciled, and often require significant adjustments. For example, the DOD Inspector General reported that the Department recorded more than \$1.5 trillion in adjustments to component financial statements that were not supported by adequate audit trails or sufficient evidence to determine their validity. The significant financial management deficiencies discussed throughout this report underscore the challenge.

#### YEAR 2000 COMPUTING CHALLENGE

The federal government—with its widespread dependence on large-scale, complex computer systems to deliver vital public services and carry out its massive operations—faces an especially enormous and difficult task. Unless adequately confronted, Year 2000 computing challenges could lead to serious disruptions in key federal operations, ranging from national defense to benefit payments to air traffic management. Consequently, in February 1997, GAO designated the Year 2000 computing challenge across government as a high-risk area.

In response to a growing recognition of the challenge and urging from congressional leaders and others, the administration strengthened the government's Year 2000 preparation. In February 1998, the President took a major step in establishing the President's Council on Year 2000 Conversion. He established the goal that no system critical to the federal government's mission experience disruption because of the Year 2000 challenge, and charged agency heads with ensuring that this issue receives the highest priority attention.

GAO has issued over 90 reports and testimony statements detailing specific findings and made well over 100 recommendations related to the Year 2000 readiness of the government as a whole and of a wide range of individual agencies. In addition, to help agencies mitigate their Year 2000 risk, we produced a series of guides on Year 2000 readiness, business continuity and contingency planning, and testing.

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While much has been accomplished in addressing the Year 2000 challenge, risks remain. Our reviews of federal Year 2000 programs have found uneven progress; some major agencies are behind schedule. Complete and thorough Year 2000 testing is essential to providing reasonable assurance that new or modified systems will be able to process dates correctly and not jeopardize agencies' ability to perform core business operations. Moreover, adequate business continuity and contingency plans must be successfully completed throughout government.

FINANCIAL STATEMENTS AND BUDGET DECISIONS:  
ADDING THE LONG-TERM PERSPECTIVE

A view of the long-term sustainability of fiscal policies can assist decisionmakers in considering the government's financial position and making decisions about resource allocation. Such a view requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the commitments of social insurance programs—such as Social Security and Medicare—must be considered.

Commitments for the Social Security and Medicare programs are included in the Stewardship Information accompanying the financial statements. The government's 75 year estimates of the present value of expenditures in excess of contributions for the Social Security (Old Age Survivors and Disability Insurance (OASDI)) and Medicare (Part A) programs amounted to \$3.8 trillion and \$4.0 trillion, respectively, as of September 30, 1998. The government's projections also indicate that Social Security and health care costs will absorb an increasing share of the federal budget.

In fiscal year 1998, Social Security trust funds surpluses of \$99 billion offset a \$30 billion deficit in the rest of the budget, resulting in the \$69 billion unified budget surplus. However, as discussed in the accompanying Stewardship Information, using the government's best estimates as of September 30, 1998, cash disbursements of the Social Security trust funds (OASDI) are expected to exceed cash receipts beginning in fiscal year 2013. Cash disbursements of Medicare's Hospital Insurance Program (Part A) have exceeded receipts for several years.

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When receipts exceed disbursements, trust funds invest the surplus in Treasury securities, which are assets to the trust funds and liabilities to the Treasury. As disclosed in note 9 and 17, both the investments and liabilities, which amounted to \$1.8 trillion at September 30, 1998, are netted out in the accompanying financial statements.

Expected cash shortfalls in the trust funds will require them to redeem their investments in Treasury securities. When this occurs, the government must fund these redemptions through use of future surpluses if available, lower relative spending for other federal programs, higher relative taxes, and/or greater relative borrowing from the public. Further, under the government's September 30, 1998 projections, absent any program or financing change, the Medicare Part A Trust Fund and Social Security trust funds will exhaust their Treasury security holdings in 2008 and 2032, respectively.

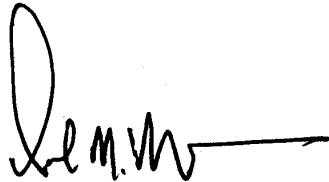
There is general recognition that the Social Security and Medicare Hospital Insurance (Part A) programs require changes from their current form. This is why today various proposals are being considered to deal with the long-term solvency and sustainability of these two programs. The fact that Medicare is already drawing down its Treasury securities holdings, and that it is expected that Social Security will need to do so in less than 15 years, highlights the importance of acting soon in order to avoid more dramatic changes in the future.

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We are working with OMB, the Treasury, and other agencies across government to provide recommendations for fixing the major deficiencies cited in our audit. Considerable effort is now being exerted to address the problems, and several agencies, such as SSA, have made good progress toward achieving financial management reform goals. We have designated the most serious situations as high-risk, including financial management at DOD, IRS, the Forest Service, and the Federal Aviation Administration, as well as information security and the Year 2000 challenge.

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In addition, the continued coordinated efforts of Treasury and OMB will be required to provide solutions for certain governmentwide deficiencies, such as the inability to properly identify and eliminate transactions between federal entities and the compilation of the financial statements. We will continue to provide suggestions for resolving governmentwide problems and to evaluate progress in overcoming them.

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David M. Walker  
Comptroller General  
of the United States

March 19, 1999

## APPENDIX

## APPENDIX

OBJECTIVES, SCOPE, AND METHODOLOGY

The federal government is responsible for

- preparing the annual financial statements accurately and in conformity with the basis of accounting described in note 1 to the financial statements;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met<sup>7</sup>; and
- complying with applicable laws and regulations.

Our objective was to audit the fiscal year 1998 financial statements.

The Government Management Reform Act expanded on the requirements of the CFO Act by requiring that the IGs of 24 major federal agencies annually audit agencywide financial statements prepared by these agencies.<sup>8</sup> Our work was performed in close coordination and cooperation with the IGs to achieve our joint audit objectives. This work included separate GAO audits of certain material agency components, as discussed below. Our audit approach focused on the Departments of the Treasury, Defense, and Health and Human Services and the Social Security Administration. These agencies comprise a major portion of the amounts reported in the federal government's financial statements. At other federal agencies, we focused largely on accounts that are material to the financial statements. Additionally, for certain agencies, information has been included in these financial statements but the agencies have not, at this date, finalized their individual financial statements for fiscal year 1998. Therefore, we were

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<sup>7</sup> The FMFIA requires agency managers to evaluate and report annually to the President and the Congress on the adequacy of their internal controls and accounting systems and what is being done to correct the problems.

<sup>8</sup> GMRA authorized OMB to designate agency components that also would receive a financial statement audit.



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unable to determine the reliability of the amounts included in the accompanying financial statements for these agencies. We performed sufficient audit work to provide our report on the financial statements, internal control, and compliance with laws and regulations.

We separately audited the following material agency components.

- We audited and expressed an unqualified opinion on the IRS Statement of Custodial Activity for fiscal year 1998. IRS was able to reliably report on the results of its custodial activities, including nearly \$1.8 trillion of tax revenue, \$151 billion of tax refunds, and \$26 billion of net federal taxes receivable. However, we issued a qualified opinion on the IRS administrative balance sheet, disclaimed an opinion on its administrative statements of net cost, changes in net position, budgetary resources, and financing, and reported numerous material internal control weaknesses.<sup>9</sup>
- We audited and expressed an unqualified opinion on the Schedule of Federal Debt Managed by Treasury's Bureau of the Public Debt for the fiscal year ended September 30, 1998.<sup>10</sup> This schedule reported (1) \$3.7 trillion of federal debt held by the public comprising individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks, (2) \$1.8 trillion of federal debt held by federal entities, such as the Social Security trust funds, and (3) \$243 billion of interest on federal debt held by the public.
- We performed audit procedures on cash balances maintained and internal controls over the cash receipts and disbursements processed by Treasury on behalf of the federal government. We provided the results of our work to the Treasury Office of Inspector General for

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<sup>9</sup> Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

<sup>10</sup> Financial Audit: Bureau of the Public Debt's Fiscal Years 1998 and 1997 Schedules of Federal Debt (GAO/AIMD-99-70, March 1, 1999).

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consideration in its audit of Treasury's fiscal year 1998 departmentwide financial statements.

- We audited and expressed unqualified opinions on the December 31, 1997, financial statements for 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.<sup>11</sup> In addition, we performed audit procedures and tests of internal controls for cash, investments, and other material balances of the funds administered by FDIC as of September 30, 1998.

At the 24 CFO Act agencies and other agencies, we reviewed the fiscal year 1998 financial statement audits performed by the IGs or their contractors and, for certain agencies, assisted in the development of audit plans for fiscal year 1998 audits. Financial statements and audit reports for these agencies provide additional information about the operations of each of these entities. For example, these audits have identified numerous internal control and accounting systems weaknesses and noncompliance, some of which are material to the respective agencies or components. Further, as of the completion of our field work on March 19, 1999, 15 of the 24 CFO Act agencies had received audit opinions or disclaimers on their fiscal year 1998 financial statements. Of the 15 agencies, 7 received unqualified opinions. These agencies are the

Social Security Administration,  
Department of Labor,  
General Services Administration,  
National Science Foundation,  
National Aeronautics and Space Administration,  
Nuclear Regulatory Commission, and  
Federal Emergency Management Agency.

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<sup>11</sup> Financial Audit: Federal Deposit Insurance Corporation's 1997 and 1996 Financial Statements (GAO/AIMD-98-204, June 29, 1998).