FEDERAL FINANCIAL STATEMENTS FOR FISCAL YEAR 2007: FISCAL OUTLOOK, MANAGEMENT WEAKNESSES AND CONSEQUENCES

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

JUNE 5, 2008

Serial No. 110–96

Printed for the use of the Committee on Oversight and Government Reform

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html
http://www.oversight.house.gov

U.S. GOVERNMENT PRINTING OFFICE

45–612 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
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FEDERAL FINANCIAL STATEMENTS FOR FISCAL YEAR 2007: FISCAL OUTLOOK, MANAGEMENT WEAKNESSES AND CONSEQUENCES

THURSDAY, JUNE 5, 2008

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
ORGANIZATION, AND PROCUREMENT,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:14 p.m., in room 2154, Rayburn House Office Building, Hon. Edolphus Towns (chairman of the subcommittee) presiding.

Present: Representatives Towns, Welch, and Bilbray.

Staff present: Michael McCarthy, staff director; William Jusino, professional staff member; Kwane Drabo, clerk; and Alex Cooper, minority professional staff member.

Mr. TOWNS. The hearing will come to order.

Welcome to today's oversight hearing on financial management in the Federal Government. Today we will discuss an important issue for Congress and for the Oversight Committee. As stewards of taxpayer dollars, it is our duty to ensure full transparency and accountability over the Federal Government's operation and fiscal condition. We must have a full understanding of the Federal Government's finances in order to fulfill this duty. We must ensure that taxpayer dollars are spent as efficiently as possible and that they are protected from waste and abuse.

I am happy to say that there have been some improvements since last year. For the first time, GAO was able to give an unqualified opinion on the 2007 Statement of Social Insurance, which is a big step for the Federal Government. GAO also reports some improvement to accounting and financial reporting standards, which provide greater transparency. OMB has reported that 14 additional programs measured and reported their improper payments in fiscal year 2007, which gives us a better understanding of this problem. Seven out of the 24 CFO Act agencies' auditors reported no material weaknesses and no noncompliance issues.

Having said that, we still have a lot of work ahead of us. This marks the 11th year that the GAO was unable to render an opinion on the consolidated financial statement. Only 19 of the 24 CFO Act agencies received clean audit opinions, the same number as last year. Thirteen of the agencies did not comply with at least one of the three requirements under the Federal Financial Management Improvement Act. Some of these agencies just aren't performing the basic accounting work that they are required by law to do. This situation is unacceptable.

The weaknesses that prevented GAO from offering its opinions relate to measures of financial reporting, things like reconciling accounting between agencies, recording agencies' assets and costs of operations and estimating loan guarantee liabilities. The Department of Defense has longstanding problems with these and other financial management issues, and I hope that we can hear some solutions today.

We just can't afford those problems. GAO says that the coming years are going to be difficult as the baby boom generation starts to retire and collect Social Security and Medicare benefits. We have a lot to do to make sure we will meet all of our commitments in the coming year. Weak financial management is the last thing that we need.

So today we will hear more about these problems.

And let me conclude and ask now to give time to Congressman Bilbray, the ranking member from California.

[The prepared statement of Hon. Edolphus Towns follows:]

ONE HUNDRED TENTH CONGRESS

Congress of the United States

House of Representatives

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SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

OVERSIGHT HEARING

Federal Financial Statements for FY 2007: Fiscal Outlook, Management Weaknesses and Consequences

Thursday, June 5, 2008
Room 2154 Rayburn House Office Building

OPENING STATEMENT OF CHAIRMAN TOWNS

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Today, we will hear more about these problems and about what is being done to solve them. Some of the issues we will discuss include improper payments, abuse of government purchasing cards, and the progress in modernizing financial management systems. I look forward to hearing from our witnesses and working with them to make our government's financial management more accountable, efficient, and effective.

Mr. BILBRAY. Thank you, Mr. Chairman.

Mr. Chairman, traditionally, the ranking member thanks the Chair for holding the hearing. I'm not going to do that today. I'm going to instead thank you for the attitude and the approach in which you address this issue and the attitude that you've taken in holding this hearing. I think that in a time when partisan bickering and brinksmanship and political advantage seems to be the role of the day, your leadership shows on this issue that outcome really does matter. And the fact is, this is an issue that I think historically we can look back and say the challenge, the improvements and the problems transcend partisanship.

We've had a Republican—I mean, a Republican administration executive branch with a Democratic majority in the House. Prior to that, we had a Democrat administration with a Republican majority in the House. And the progress and the challenges have transcended those political lines.

I just want to say sincerely, I really appreciate your approach here, because I think, rather than finding blame, we are looking for answers. We're recognizing the challenges. This is a foundation that has to be laid if we're going to have a viable financial structure for future generations. And I think that to be able to address the challenge before us, this committee and all of Congress, including the White House with the cooperation of Congress, needs to be able to work together and leave those partisan lines behind. Because, let's face it, our children and our great grandchildren are not going to ask if it was a Democrat or Republican that left us out in the cold. They're just going to know that America and its leaders did it.

So, Mr. Chairman, I say sincerely, I have looked at the panel we have and, most importantly, the way you structured this thing, and I think that you have structured it in a way that allows all of us to work together for our great grandchildren. And so, we'll continue the progress, slow and tedious and frustrating as it has been, so that in the long run, we make sure that we have an answer that does not serve the Democrat or the Republican party but serves the American people. And thank you very much for your leadership.

Mr. TOWNS. Thank you. Thank you for your words. Thank you so much. Now I'll yield time to Congressman Welch.

Mr. WELCH. In the interest of time, I yield back to the chairman.

Mr. TOWNS. Thank you very much.

We return now to our panel. It is longstanding committee policy that we swear in our witnesses. So please stand and raise your hands.

[Witnesses sworn.]

Mr. TOWNS. You may be seated. Let the record reflect that they all announced in the affirmative.

So why don't we start with you, Mr. Dodaro.

STATEMENTS OF GENE L. DODARO, ACTING COMPTROLLER OF THE UNITED STATES; DANIEL WERFEL, DEPUTY CONTROLLER, OFFICE OF MANAGEMENT AND BUDGET; AND J. DAVID PATTERSON, PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE (COMPTROLLER), DEPARTMENT OF DEFENSE, ACCOMPANIED BY JAMES SHORT, DEPUTY CHIEF FINANCIAL OFFICER, AND DAVID FISHER, DIRECTOR OF THE BUSINESS TRANSFORMATION AGENCY

STATEMENT OF GENE L. DODARO

Mr. DODARO. Good afternoon, Mr. Chairman, Congressman Bilbray, Congressman Welch. It is a pleasure to be invited here to talk about the results from GAO's audit for the consolidated financial statements for fiscal year 2007.

As you mentioned in your opening statement, like prior years, we are unable to provide an opinion on the accrual-based financial statements. While there are a lot of reasons for that and problems and weaknesses, we have identified there are three primary impediments. First, there are serious financial management problems at the Department of Defense; second is the inability to properly record and eliminate intergovernmental transactions between Federal agencies; and, third, there are problems with the compilation of the financial statements by the Department of Treasury.

Now, as you mentioned, this year, although we have had a similar overall outcome on the accrual-based financial statements, there have been some market progress.

First, we were able to provide an unqualified opinion on the Statement of Social Insurance. This is very important, shedding some light on the Federal Government's long-term fiscal exposures, as this statement displays the fact that the net present value of the commitments for Social Security and Medicare, for example, are $41 trillion over the next 75-year period.

Second, the administration, working with both OMB and Treasury, produced a summary financial statement, which is very short and concise, and it puts in understandable terms the financial statements of the Federal Government and the long-term fiscal challenges facing the government going forward. So we think that was a tremendous addition this past year as well.

Now, DOD and Treasury and many of the other Federal agencies have plans under way to try to address some of these longstanding weaknesses that have been in place, and it is very, very important for progress to be sustained. We have a transition in administration coming up, and this administration needs to continue to work hard on these activities as they have been up until that point in time. And they don't have to be picked up again by the next administration going forward so we can continue to make progress in these areas.

Now, it is not only important for accountability, but it is important to understand the long-term fiscal position of the Federal Government. If I could direct your attention to this chart that we have over here to highlight a couple of trends that the financial statements show.

This first chart talks about the increase in the total Federal debt that the Federal Government owes. As it shows, in the last 4 years alone, the total Federal debt has climbed from about $6.5 trillion up to $9 trillion at the end of fiscal year 2007. Now, the debt—the shaded part at the bottom is debt held by the public, and that has gone up as well as the white portion, which is the intergovernmental holdings. That is largely the money that the Federal Government is using from the Social Security revenues in excess of expenditures to pay for current obligations of the Federal Government.

Now, the debt—the $9 trillion—right now, the debt ceiling is set at about $9.8 trillion. So it is expected that sometime next fiscal year, the Federal Government will hit that debt ceiling again, and there will have to be additional action taken by the Congress. So this is a trend. The financial statements are showing some light on this.

But this situation, as I'm going to show in the next slide, where the Federal Government has this excess revenue from Social Security, from payroll taxes over expenditures is going to dissipate as the baby boom generation retires.

On this next slide, this looks in the outyears. This assumes—it takes the time period from 2008 to 2040 over the next 32 years, and it shows several things.

One, it assumes that we hold revenue, basically assuming that the tax cuts will be extended through 2018; and, after 2018—the solid line represents revenue—we assume revenue recedes at 18.3 percent, which is the average of GDP, which is about the average over the last 40 years in the Federal Government's experience.

On the bottom, there are four components to the Federal spending side. The bottom, the darker shaded area, is interest on the national debt. That shows going up the second component of the bar is Social Security, the third component is Medicare, and then the white portion at the top is all other spending for the Federal Government. This includes defense and all other discretionary spending.

What this shows is that by the year 2030, the Federal Government, assuming historic revenue collections, would only have enough revenues to pay interest on the debt, Social Security payments and Medicare payments. It wouldn't have enough money left to fund any other activity in the Federal Government, and that even becomes more acutely painful in 2040. Now, obviously, our country will not let this happen, but it shows the magnitude of the fiscal challenge ahead.

Simply put, the Federal Government is on an unsustainable fiscal path and that action is urgently needed to begin to address some of these issues, both entitlement spending, the base in government and to look at the revenue side of government as well going forward.

So, Mr. Chairman, I commend you and the committee for continuing to focus on making improvements in Federal financial management. It is urgently important. It is tough work, as was mentioned by Congressman Bilbray, going forward every year, but it is very important. So I commend this committee for its diligence on this, and I'd be happy when we get to the question-and-answer period to answer any questions.

Mr. TOWNS. Thank you very much.

[The prepared statement of Mr. Dodaro follows:]

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

For Release on Delivery
Expected at 2:00 p.m. EDT
Thursday, June 5, 2008

FISCAL YEAR 2007 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Financial Management Is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge

Statement of Gene L. Dodaro
Acting Comptroller General of the United States

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GAO-08-847T

June 5, 2008

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Highlights

Highlights of GAO-08-847T, a testimony before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

FISCAL YEAR 2007 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Financial Management Is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge

Why GAO Did This Study

The Congress and the President need to have reliable, useful and timely financial and performance information to make sound decisions on the current and future direction of vital federal government programs and policies.

Unfortunately, except for the 2007 Statement of Social Insurance, GAO was again unable to provide assurance on the reliability of the consolidated financial statements of the U.S. government (CFS) due primarily to certain material weaknesses in the federal government's internal control. GAO has reported that unless these weaknesses are adequately addressed, they will, among other things, (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities.

This testimony presents the results of GAO's audit of the CFS for fiscal year 2007 and discusses the federal government's long-term fiscal outlook.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management, including ones regarding issues addressed in this testimony.

To view the full product, including the scope and methodology, click on GAO-08-847T. For more information, contact McCoy Williams or Gary T. Engel at (202) 512-2600 or Susan Irving at (202) 512-9142.

What GAO Found

For the 11th consecutive year, three major impediments prevented GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. In addition, financial management system problems continue to hinder federal agency accountability. Although the federal government still has a long way to go, significant progress has been made in improving federal financial management. For example, audit results for many federal agencies have improved and federal financial system requirements have been developed. In addition, GAO was able to render an unqualified opinion on the 2007 Statement of Social Insurance. Further, for the first time, the federal government issued a summary financial report which is intended to make the information in the *Financial Report of the U.S. Government* (*Financial Report*) more understandable and accessible to a broader audience.

It is important that this progress be sustained by the current administration as well as the new administration that will be taking office next year and that the Congress continues its oversight to bring about needed improvements to federal financial management. Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting, can help increase understanding of the nation's long-term fiscal outlook.

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path. Addressing this challenge will require a multipronged approach. Moreover, the longer that action is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

Finally, the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. A broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2007 and 2006. I would like to thank you for continuing the annual tradition of oversight hearings on this important subject. The involvement of your subcommittee remains critical to ultimately assuring the continued progress in improving federal financial management while enhancing public confidence in the government as a steward that is accountable for its finances. Such hearings play a vital role in ensuring that the federal government is held accountable to the American people.

In this testimony, I will discuss (1) the major issues relating to the consolidated financial statements for fiscal years 2007 and 2006, including progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements; (2) financial management systems problems that continue to hinder federal agency accountability; (3) the challenges posed by the federal government's long-term fiscal condition and GAO's views on a possible way forward; and (4) the need for an improved federal financial reporting model. Until these issues are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Both the consolidated financial statements and our related audit report are included in the fiscal year *2007 Financial Report of the United States Government* (*Financial Report*).[1] The *Financial Report* was issued by the Department of the Treasury (Treasury) on December 17, 2007.[2] In addition, for the first time, Treasury and the Office of Management and Budget (OMB) in coordination with GAO issued on February 14, 2008, a summary financial report entitled, *The Federal Government's Financial Health: A Citizens Guide to the 2007 Financial Report of the United States Government*. This guide is intended to make the information in the *Financial Report* more understandable and more accessible to a broader audience. The Director of OMB, the Secretary of the Treasury, and I

[1]Our audit work regarding the U.S. government's consolidated financial statements was conducted in accordance with U.S. generally accepted government auditing standards.

[2]Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005), which was prepared to help those who seek to obtain a better understanding of the *Financial Report*.

believe that the information discussed in this guide is important to all Americans. This is a good first step, and I am confident that the guide will evolve over time. Both of these reports are available through GAO's Internet site, at http://www.gao.gov/financial/fy2007financialreport.html and Treasury's Internet site, at http://www.fms.treas.gov/fr/index.html.

Summary

Certain material weaknesses[3] in financial reporting and other limitations on the scope of our work resulted in conditions that for the 11th consecutive year prevented us from providing the Congress and the American people an opinion on the federal government's financial statements, other than the Statement of Social Insurance, which are referred to as the federal government's accrual basis consolidated financial statements.[4] However, since the enactment of key financial management reforms in the 1990's, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix III, for fiscal year 2007, 19 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements. In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. In addition, federal financial systems requirements have been developed. Also, accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. Further, fiscal year 2007 marked the second year in which the Statement of Social Insurance has been provided as a basic financial statement.[5] The

[3]A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

[4]Most revenues reported in the accrual basis consolidated financial statements are recorded on a modified cash basis.

[5]We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance. Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

Statement of Social Insurance displays the present value[6] of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). Importantly, we were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government.

The federal government, however, still has a long way to go to address several principal challenges to fully realizing strong federal financial management.[7] For example, three major impediments continue to prevent GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Further, in our opinion, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations as of September 30, 2007, due to numerous material weaknesses. Moreover, financial management system problems continue to hinder federal agency accountability.

In our audit report, we also emphasized that the federal government's current fiscal path is unsustainable and that tough choices by the Congress and the President are necessary to address the nation's long-term fiscal challenge. The fiscal and cash flow implications of the federal government's large and growing Social Security and Medicare commitments will be felt as the large baby boom generation leaves the work force and collects benefits. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits. The budget and economic implications of the baby boom generation's retirement will only intensify as the baby boomers age. Given these and other factors, it seems clear that the nation is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time. The issues raised by this long-term fiscal challenge are issues of significance that affect every American. Committed leadership and

[6]Present value is the discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.

[7]GAO, *Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation*, GAO-07-542T (Washington, D.C.: Mar. 1, 2007).

sustained efforts by the Congress, the President, and other key individuals throughout the federal financial management community will be needed to put our nation on a more prudent and sustainable long-term fiscal path. Given the government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government's long-term fiscal outlook.

Finally, we believe the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. The current reporting model recognizes some of these needs; however, a broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2007 and 2006

As has been the case for the previous 10 fiscal years, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the U.S. government's accrual basis consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's accrual basis consolidated financial statements for the fiscal years ended 2007 and 2006.[8] Appendix I describes the material weaknesses that contributed to our disclaimer of opinion in more detail and highlights the primary effects of these material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations.

[8]We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2006.

The material weaknesses that contributed to our disclaimer of opinion were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the consolidated financial statements;
- implement effective credit reform estimation and related financial reporting processes at certain federal credit agencies;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government's consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) properly balanced, and (3) in conformity with Generally Accepted Accounting Principles; and,
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies' financial statements and underlying financial information and records.

Due to the material weaknesses and the additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the accrual basis consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found three other material weaknesses in internal control as of September 30, 2007. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations. These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur,
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

Further, our audit report discusses certain significant deficiencies in internal control at the governmentwide level.[9] These significant deficiencies involve the following areas:

- preparing the Statement of Social Insurance for certain programs, and
- monitoring and oversight regarding certain federal grants and entities that offer Medicare health plan options.

Individual federal agency financial statement audit reports identify additional control deficiencies which were reported by agency auditors as material weaknesses or significant deficiencies at the individual agency level. We do not deem these additional control deficiencies to be material weaknesses at the governmentwide level.

Regarding agencies' internal controls, in December 2004, OMB revised OMB Circular No. A-123, *Management's Responsibility for Internal Control*, which became effective for fiscal year 2006. In fiscal year 2006, agencies began to implement the more rigorous requirements of the revised OMB Circular No. A-123, which include management identification, assessment, testing, correction, and documentation of internal controls over financial reporting for each account or group of accounts, as well as an annual assurance statement from the agency head as to whether internal control over financial reporting is effective.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multiyear implementation plans. According to OMB's *Federal Financial Management Report for 2007*, 16 of the 24 CFO Act agencies have performed assessments required by OMB Circular No. A-123 for all key processes, while the remaining 8 CFO Act agencies are phasing in implementation of the requirements by testing a portion of the key processes and providing plans for testing the remaining processes within 3 years. Also, according to that report, to

[9]See page 182 of the *Financial Report* for more details regarding these significant deficiencies.

achieve its strategic goal of improving effectiveness of internal control over financial reporting, OMB has developed priority actions that include updating guidance, as necessary, based on lessons learned from agencies' implementation of the circular. It will be important that OMB continue to monitor and oversee federal agencies' implementation of these new requirements.

Addressing Major Impediments to an Opinion on the Accrual Basis Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's accrual basis consolidated financial statements continued to be: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Extensive efforts by DOD officials and cooperative efforts between agency chief financial officers, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's accrual basis consolidated financial statements.

Financial Management at DOD

Essential to further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements is the resolution of serious weaknesses in DOD's business operations. DOD is one of the largest and most complex organizations in the world. Since the first financial statement audit of a major DOD component was attempted almost 20 years ago, we have reported that weaknesses in DOD's business operations, including financial management, not only adversely affect the reliability of reported financial data, but also the economy, efficiency, and effectiveness of its operations.

DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement, bearing responsibility, in whole or in part, for 15 of 27 high-risk areas.[10] Eight of these areas are specific to DOD and include DOD's overall approach to business transformation, as well as business systems modernization and financial management. Collectively, these high-risk areas relate to DOD's major business operations, including financial management, which directly support the warfighters, including their pay, the benefits provided to their

[10]GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007).

families, and the availability and condition of equipment and supplies they use both on and off the battlefield.

Successful transformation of DOD's financial management operations will require a multifaceted, cross-organizational approach that addresses the contribution and alignment of key elements, including sustained leadership, strategic plans, people, processes, and technology. Congress clearly recognized, in the National Defense Authorization Act for Fiscal Year 2008,[11] the need for executive-level attention in ensuring that DOD was on a sustainable path toward achieving business transformation. This legislation codifies Chief Management Officer (CMO) responsibilities at a high level in the department—assigning them to the Deputy Secretary of Defense—and establishing a full-time Deputy CMO and designating CMO responsibilities within the military services. However, in less than a year, our government will undergo a change in administrations, which raises questions about the continuity of effort and the sustainability of the progress that DOD has made to date. As such, we believe the CMO position should be codified as a separate position from the Deputy Secretary of Defense in order to provide full-time attention to business transformation over the long term, subject to an extended term appointment. Because business transformation is a long-term and complex process, we have recommended a term of at least 5 to 7 years to provide sustained leadership and accountability.

Importantly, DOD has taken steps toward developing and implementing a framework for addressing the department's long-standing financial management weaknesses and improving its capability to provide timely, reliable, and relevant financial information for analysis, decision making, and reporting, a key defense transformation priority. Specifically, this framework, which is discussed in both the department's Enterprise Transition Plan (ETP)[12] and the Financial Improvement and Audit Readiness (FIAR) Plan,[13] includes the department's Standard Financial

[11]Pub. L. No. 110-181, § 904 (2008).

[12]The Enterprise Transition Plan is intended to describe how DOD will transition from its current or "as is" operational environment to its intended or "to be" operational capabilities. The Business Transformation Agency is the DOD agency responsible for DOD's business transformation and the development and implementation of the ETP.

[13]DOD's FIAR Plan, initially issued in December 2005 and updated each June and September, is intended to provide DOD components with a framework for resolving problems affecting the accuracy, reliability, and timeliness of financial information and obtaining clean financial statement audit opinions.

Information Structure (SFIS) and Business Enterprise Information System (BEIS). DOD intends this framework to define and put into practice a standard DOD-wide financial management data structure as well as enterprise-level capabilities to facilitate reporting and comparison of financial data across the department.

DOD's efforts to develop and implement SFIS and BEIS should help to improve the consistency and comparability of the department's financial information and reporting; however, a great deal of work remains before the financial management capabilities of DOD and its components' transformation efforts achieve financial visibility.[14] Examples of work remaining include data cleansing; improvements to current policies, processes, procedures, and controls; and implementation of fully integrated systems.

In 2007, DOD introduced refinements to its approach for achieving financial statement auditability. These refinements include the following:

- Requesting audits of entire financial statements rather than attempting to build upon audits of individual financial statement line items.
- Focusing on improvements in end-to-end business processes, or segments[15] that underlie the amounts reported on the financial statements.
- Using audit readiness validations and annual verification reviews of segment improvements to help ensure sustainability of corrective actions and improvements.
- Forming a working group to begin auditability risk assessments of financial systems at key decision points in their development and deployment life cycle to help ensure that the processes and internal controls support repeatable production of auditable financial statements.

We are encouraged by DOD's efforts and emphasize the necessity for consistent management oversight toward achieving financial management capabilities and reporting of meaningful and measurable transformation

[14]DOD defines financial visibility as providing immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost information) in support of financial accountability and efficient and effective decision making through the department in support of the missions of the warfighter.

[15]DOD defines a segment as a component of an entity's business and financial environment. A segment can include (1) complete or partial business processes; (2) financial systems, business systems, or both; or (3) commands or installations. According to DOD, the environment's complexity, materiality, and timing of corrective actions are all factors that are taken into consideration when defining a segment.

effort benchmarks and accomplishments. We will continue to monitor DOD's efforts to transform its business operations and address its financial management challenges as part of our continuing DOD business enterprise architecture and financial audit readiness oversight.

Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions and called for the establishment of an Intragovernmental Dispute Resolution Committee.

OMB is currently working with the Chief Financial Officers Council to create the Intragovernmental Dispute Resolution Committee.[16] Treasury is also taking steps to help resolve material differences in intragovernmental activity and balances. For example, Treasury is requiring federal agencies to provide a plan of action on how the agency is addressing certain of its unresolved material differences. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules and continued strong leadership by OMB and Treasury.

Preparing the Consolidated Financial Statements

Although further progress was demonstrated in fiscal year 2007, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP).[17] Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. During fiscal year 2007, Treasury, in coordination with OMB, continued to develop and implement corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a

[16] The U.S. Chief Financial Officers Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of OMB and Treasury who work collaboratively to improve financial management in the U.S. government.

[17] Most of the issues regarding the preparation of the consolidated financial statements that we identified in fiscal year 2007 existed in fiscal year 2006, and many have existed for a number of years. In July 2007, we reported the issues we identified to Treasury and OMB and provided new recommendations for corrective action and discussed the status of certain previously issued recommendations in GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in the Preparation of the Consolidated Financial Statements of the U.S. Government*, GAO-07-805 (Washington, D.C.: July 23, 2007).

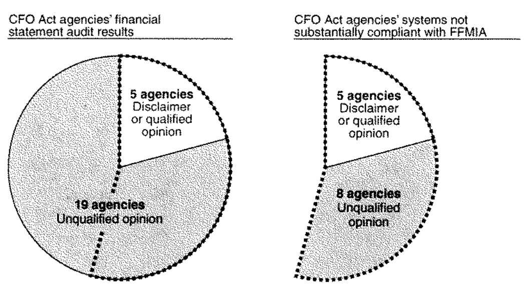
difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

Federal Agencies' Financial Management Systems

Under the Federal Financial Management Improvement Act of 1996 (FFMIA), as a part of the CFO Act agencies' financial statement audits, auditors are required to report whether agencies' financial management systems comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. These factors, if implemented successfully, help provide a solid foundation for improving accountability over government operations and routinely producing sound cost and operating performance information.

As shown in figure 1, 19 out of the 24 CFO Act agencies received an unqualified opinion on their financial statements in fiscal year 2007; however, 8 of these 19 agencies' systems did not substantially comply with one or more of the three FFMIA requirements. This shows that irrespective of these unqualified "clean" opinions on the financial statements, many agencies still do not have reliable, useful and timely financial information with which to make informed decisions and ensure accountability on an ongoing basis.

Figure 1: Comparison of 2007 Financial Statement Audit Results to FFMIA Assessments



Source: CFO Act agencies.

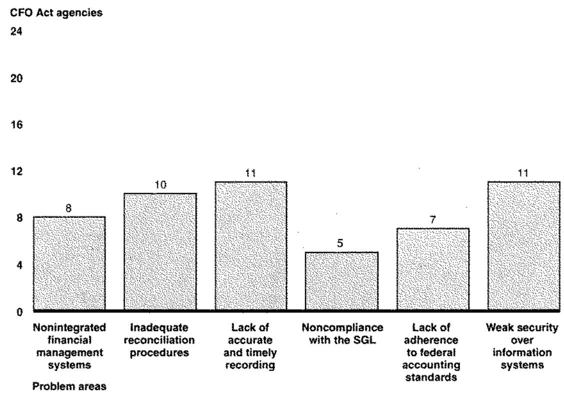
Note: Data are compiled from CFO Act agencies' Performance and Accountability Reports for fiscal year 2007.

The modernization of federal financial management systems has been a long-standing challenge at many federal agencies. As shown in figure 1, auditors reported that 13 of the 24 CFO Act agencies' systems did not substantially comply with one or more of the three FFMIA requirements for fiscal year 2007. This compares with 17 agencies for fiscal year 2006. Although the number of agencies reported as not substantially compliant has declined, the federal government's capacity to manage with timely and useful data remains limited, thereby hampering its ability to effectively administer and oversee its major programs.

For fiscal year 2007, noncompliance with federal financial management systems requirements was the most frequently cited deficiency of the three FFMIA requirements. One of the federal financial management systems requirements is for agencies to have integrated financial management systems. Based on our review of the fiscal year 2007 audit reports, we identified the lack of integrated financial management systems to be one of the six problem areas for the 13 agency systems that are reported as not being substantially compliant with FFMIA. Figure 2 summarizes these six areas and the number of agencies with problems reported in each area.[18]

[18]The same six types of problems have been cited by auditors although the auditors may not have reported these problems as specific reasons for the agency systems not being substantially compliant with the FFMIA requirements.

Figure 2: Number of CFO Act Agencies with Reported FFMIA Compliance Problems for Fiscal Year 2007



Source: GAO analysis based on independent auditors' financial statement audit reports prepared by agency inspectors general and contract auditors for fiscal year 2007.

The lack of integrated financial management systems typically results in agencies expending major time, effort, and resources, including in some cases, hiring external consultants to develop information that their systems should be able to provide on a daily or recurring basis. In addition, nonintegrated systems are more prone to error which could result in information that is not reliable, useful, or timely. Figure 2 also shows that auditors for 11 CFO Act agencies had reported the lack of accurate and timely recording of financial information as a problem in fiscal year 2007. Accurate and timely recording of financial information is essential for effective financial management. Furthermore, the majority of participants at a recent Comptroller General's forum[19] on improving financial management systems agreed that financial management systems are not able to provide, or provide little, information that is reliable, useful, and timely to assist management in their day-to-day decision making, which is the ultimate goal of FFMIA.

Participants at the forum also discussed current financial management initiatives and the strategies for transformation of federal financial management. To reduce the cost and improve the outcome of federal financial management systems implementations, OMB continues to move forward on a key initiative—the financial management line of business (line of business), by leveraging common standards and shared solutions. OMB anticipates that the line of business initiative will help achieve the goals of improving the cost, quality, and performance of financial management operations. OMB and the Financial Systems Integration Office have demonstrated continued progress toward implementation of the line of business initiative by issuing a common governmentwide accounting classification structure, financial services assessment guide, and exposure drafts of certain standard business processes. However, as we previously recommended,[20] OMB needs to continue defining standard business processes. A critical factor for success will be ensuring that agencies cannot continue developing and implementing their own stovepiped systems. Failure to do so may require additional work, increase costs to adopt these standard business processes, and further delay the transformation of federal financial management systems.

In a January 2008 memo, OMB recognized the risks associated with nonstandardized processes and updated its guidance on the line of business. Current plans are for the Financial Systems Integration Office to continue developing business standards and incorporate them into software requirements and permit agencies and shared service providers

[19] On December 11, 2007, the Comptroller General of the United States hosted a forum in Washington, D.C., attended by Chief Financial Officers, Chief Information Officers, Inspectors General (IG) from several of the 24 CFO Act agencies, and other knowledgeable officials in the public and private sector, to discuss issues related to effective financial management system implementation across the federal government and to address long-standing federal financial management issues. See GAO, *Highlights of a Forum: Improving the Federal Government's Financial Management Systems*, GAO-08-447SP (Washington, D.C.: Apr. 16, 2008).

[20] GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, GAO-06-184 (Washington, D.C.: Mar. 15, 2006).

to utilize only the certified products as configured. Along with these changes, continued high-priority and sustained top-level commitment by OMB and leaders throughout the federal government will be necessary to fully and effectively achieve the common goals of the line of business and FFMIA.

The Nation's Long-Term Fiscal Challenge

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. There is a need to engage in a fundamental review of what the federal government does, how it does it, and how it is financed. Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to maintain fiscal flexibility so that policymakers can respond to current and emerging social, economic, and security challenges.

While some progress has been made in recent years in addressing the federal government's short-term fiscal condition, the nation has not made progress on its long-term fiscal challenge. However, even this short-term deficit is understated: It masks the fact that the federal government has been using the Social Security surplus to offset spending in the rest of government for many years. If the Social Security surplus is excluded, the on-budget deficit[21] in fiscal year 2007 was more than double the size of the unified deficit. For example, Treasury reported a unified deficit of $163 billion and an on-budget deficit of $344 billion in fiscal year 2007.

While the federal government's unified budget deficit has declined in recent years, its liabilities, contingencies and commitments, and social insurance responsibilities have increased. As of September 30, 2007, the U.S. government reported in the 2007 Financial Report that it owed (i.e., liabilities) more than it owned (i.e., assets) by more than $9 trillion. Further, the Statement of Social Insurance in the Financial Report disclosed $41 trillion in social insurance responsibilities, including Medicare and Social Security, up more than $2 trillion from September 30, 2006.

[21]The on-budget deficit includes all budgetary accounts other than those designated by law as off-budget. The off-budget accounts are the Postal Service and Social Security trust funds. The unified budget is a comprehensive measure of all federal activities, including those that are on-budget and off-budget.

Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government's long-term fiscal outlook. Over the next few decades, the nation's fiscal challenge will be shaped largely by rising health care costs and known demographic trends. As the baby boom generation retires, federal spending on retirement and health care programs—Social Security and Medicare, and Medicaid—will grow dramatically.

The future costs of Social Security and Medicare commitments are reported in the Statement of Social Insurance in the *Financial Report*. We were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government. The statement displays the present value of projected revenues and expenditures for scheduled benefits of social insurance programs. For Social Security and Medicare alone, projected expenditures for scheduled benefits exceed earmarked revenues (i.e., dedicated payroll taxes and premiums) by approximately $41 trillion over the next 75 years in present value terms. Stated differently, one would need approximately $41 trillion invested today to deliver on the currently promised benefits not covered by earmarked revenues for the next 75 years.

Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

Table 1: Simplified Statement of Social Insurance as of January 1, 2007

Dollars in trillions

	Social Security	Medicare Hospital Insurance (Part A)	Medicare Supplementary Medical Insurance (Part B)	Medicare Supplementary Medical Insurance (Part D)	Total
Present value of future revenue (earmarked contributions, taxes, and premiums)	$34	$11	$5	$2	**$52**
Present value of expenditures for scheduled future benefits[a]	41	23	18	11	**93**
Present value of future expenditures in excess of future revenue[b]	($7)	($12)	($13)	($8)	**($41)**

Source: The Department of the Treasury.

Notes: Data are from the fiscal year 2007 Financial Report. Totals do not necessarily equal the sum of the components due to rounding.

[a]These amounts include administrative expenses for the programs.

[b]Under current law, Social Security and Federal Hospital Insurance (Medicare Part A) payments are limited to amounts available to the respective trust funds.

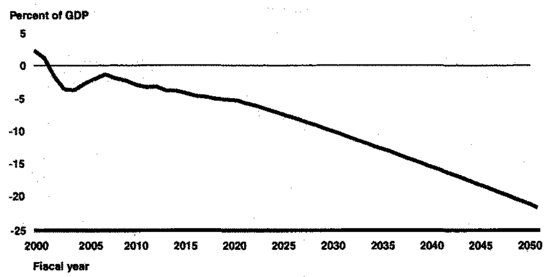
Although these social insurance commitments dominate the long-term outlook, they are not the only federal programs or activities that bind the future. GAO developed the concept of "fiscal exposures" to provide a framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending.[22] In addition to the social insurance commitments, the federal government's fiscal exposures include about $11 trillion in liabilities reported on the Balance Sheet, $1 trillion of other commitments and contingencies, as well as other potential exposures that cannot be quantified. So beyond dealing with Medicare and Social Security, policymakers need to look at other policies that limit the federal government's flexibility—not necessarily to eliminate all of them but to at least be aware of them and make a conscious decision to reform them in a manner that will be responsible, equitable, and sustainable.

Long-term fiscal simulations of future revenues and costs for all federal programs offer a comprehensive assessment of the federal government's long-term fiscal outlook. Since 1992, GAO has published long-term fiscal simulations of what might happen to federal deficits and debt levels under varying policy assumptions. GAO's simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used. For example, figure 3 shows GAO's simulation of the deficit path based on recent trends and policy preferences. In this simulation, we start with the Congressional Budget Office's (CBO) baseline and then assume that (1) all expiring tax provisions are extended through 2018—and then revenues are brought to their historical level as a share of gross domestic product (GDP) plus expected revenue from deferred taxes—(2) discretionary spending grows with the economy, and (3) no structural changes are made to Social Security, Medicare, or Medicaid.[23]

[22]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[23]Social Security and Medicare spending are based on the 2008 Trustees' intermediate projections. Medicare spending is adjusted using the Centers for Medicare and Medicaid Services' estimates assuming that physician payments are not reduced as required under current law. Medicaid spending is based on CBO's December 2007 long-term projections adjusted to reflect excess cost growth consistent with the Trustees' intermediate projections. Additional information about GAO's simulation model, assumptions, data, and results can be found at http://www.gao.gov/special.pubs/longterm/.

Figure 3: Unified Surpluses and Deficits under GAO's Alternative Simulation



Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

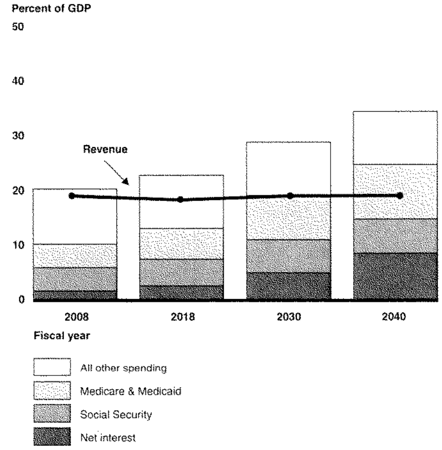
Over the long term, the nation's fiscal challenge stems primarily from rising health care costs and, to a lesser extent, the aging of the population. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today's and tomorrow's commitments.

Figure 4 looks behind the deficit path to the composition of federal spending. It shows that the estimated growth in the major entitlement programs leads to an unsustainable fiscal future. In this figure, the category "all other spending" includes much of what many think of as "government"—discretionary spending on such activities as national defense, homeland security, veterans health benefits, national parks, highways and mass transit, and foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports.[24] The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending. A

[24]Discretionary spending refers to spending based on authority provided in annual appropriations acts. Mandatory spending refers to spending that the Congress has authorized in legislation other than appropriations acts that entitles beneficiaries to receive payment or that otherwise obligates the federal government to make payment.

government that in one generation does nothing more than pay interest on its debt and mail checks to retirees and some of their health providers is unacceptable.

Figure 4: Potential Fiscal Outcomes under GAO's Alternative Simulation: Revenues and Composition of Spending as Shares of GDP

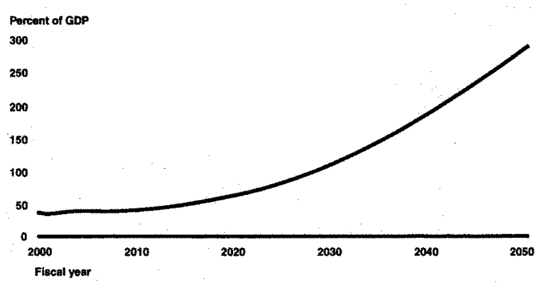


Source: GAO's April 2008 analysis.

Note: Discretionary spending grows with GDP after 2008. Alternative minimum tax exemption amount is retained at the 2007 level through 2018 and expiring tax provisions are extended. After 2018, revenue as a share of GDP returns to its historical level of 18.3 percent of GDP plus expected revenues from deferred taxes, (i.e., taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees' 2008 projections adjusted for the Centers for Medicare and Medicaid Services' alternative assumption that physician payments are not reduced as specified under current law.

The federal government's increased spending and rising deficits will drive a rising debt burden. At the end of fiscal year 2007, debt held by the public exceeded $5 trillion. Figure 5 shows that this growth in the federal government's debt cannot continue unabated without causing serious harm to the economy. In the last 200 years, only during and after World War II has debt held by the public exceeded 50 percent of GDP. But this is only part of the story. The federal government for years has been borrowing the surpluses in the Social Security trust funds and other similar funds and using them to finance federal government costs. When such borrowings occur, Treasury issues federal securities to these government funds that are backed by the full faith and credit of the U.S. government. Although borrowing by one part of the federal government from another may not have the same economic and financial implications as borrowing from the public, it represents a claim on future resources and hence a burden on future taxpayers and the future economy. If federal securities held by those funds are included, the federal government's total debt is much higher—about $9 trillion as of the end of fiscal year 2007.

Figure 5: Debt Held by the Public under GAO's Alternative Simulation

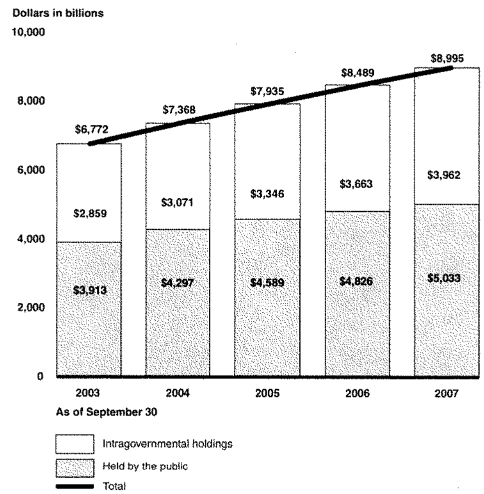


Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

As shown in figure 6, total federal debt increased over each of the last four fiscal years.

Figure 6: Total Federal Debt Outstanding



Source: The Department of the Treasury.

On September 29, 2007, the statutory debt limit had to be raised for the third time in 4 years in order to avoid being breached; between the end of fiscal year 2003 and the end of fiscal year 2007, the debt limit had to be increased by about one-third. It is anticipated that actions will need to be taken in fiscal year 2009 to avoid breaching the current statutory debt limit of $9,815 billion.

A quantitative measure of the long-term fiscal challenge measure is called "the fiscal gap." The fiscal gap is the amount of spending reduction or tax increases that would be needed today to keep debt as a share of GDP at or below today's ratio. The fiscal gap is an estimate of the action needed to achieve fiscal balance over a certain time period such as 75 years. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 5. The fiscal gap can be expressed as a share of the economy or in present value dollars.

Under GAO's alternative simulation, closing the fiscal gap would require spending cuts or tax increases equal to 6.7 percent of the entire economy over the next 75 years, or about $54 trillion in present value terms. To put this in perspective, closing the gap would require an increase in today's federal tax revenues of about 36 percent or an equivalent reduction in today's federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) to be maintained over the entire period.

Policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. The size of these annual tax increases and spending cuts would be more than five times the fiscal year 2007 deficit of 1.2 percent of GDP. Delaying action would make future adjustments even larger. Under our alternative simulation, waiting even 10 years would require a revenue increase of about 45 percent or noninterest spending cuts of about 40 percent. This gap is too large for the federal government to grow its way out of the problem. To be sure, additional economic growth would certainly help the federal government's financial condition and ability to address this fiscal gap, but it will not eliminate the need for action.

Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to the nation's future. As we reported in December 2007,[25] several countries have begun preparing fiscal sustainability reports to help assess the implications of their public pension and health care programs and other challenges in the context of overall sustainability of government finances. European Union members also annually report on longer-term fiscal sustainability. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions. These countries used a variety of measures, including projections of future revenue and spending and summary measures of fiscal imbalance and

[25]GAO, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge*, GAO-08-206 (Washington, D.C.: Dec. 20, 2007).

fiscal gaps, to assess fiscal sustainability. Last year, we recommended that the United States should prepare and publish a long-range fiscal sustainability report.[26] I am pleased to note that the Federal Accounting Standards Advisory Board (FASAB) will soon issue a draft of a proposed standard on fiscal sustainability reporting.

Here in the first half of 2008, the long-term fiscal challenge is not in the distant future. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits and will be eligible for Medicare benefits in less than 3 years. The budget and economic implications of the baby boom generation's retirement have already become a factor in CBO's 10-year budget projections and that impact will only intensify as the baby boomers age.

The financial markets also are noticing. Earlier this year, Moody's Investors Service issued its annual report on the United States. In that report, it noted that absent Medicare and Social Security reforms, the long-term fiscal health of the United States and the federal government's current Aaa sovereign credit rating were at risk. Likewise, Standard and Poor's noted in a recent report that Medicare and Social Security reform is necessary to prevent a much worse long-term fiscal deterioration. These comments serve to note the significant longer-term interest rate risk that the federal government faces absent meaningful action to address these long-range challenges. Higher longer-term interest costs would only serve to complicate the nation's fiscal, economic, and other challenges in future years.

At some point, action will need to be taken to change the nation's fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation's long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing and future generations will have to bear a greater burden of the cost. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time.

[26]GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed*, GAO-07-1144T (Washington, D.C.: July 25, 2007), and *Long-Term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today*, GAO-07-389T (Washington, D.C.: Jan. 23, 2007).

A Possible Way Forward

Meeting this long-term fiscal challenge overarches everything. It is the nation's largest sustainability challenge, but it is not the only one. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed.

In addressing the growing costs of the major entitlement programs and reexamining other major programs, policies, and activities, attention should be paid to both the spending and the revenue sides of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures[27]—must be reexamined along with those that run through the spending side. Moving forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results.

Meeting the nation's long-term fiscal challenge will require a multipronged approach bringing people together to tackle health care, Social Security, and the tax system as well as

- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and
- reengineering and reprioritizing the federal government's existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

There are also some process changes that might help the discussion by increasing the transparency and relevancy of key financial, performance, and budget reporting and estimates that highlight the fiscal challenge. Stronger budget controls for both spending and tax policies to deal with both near-term and longer-term deficits may also be helpful.

In summary, to effectively address the nation's long-term fiscal challenge, tackling health care cost growth and other existing entitlement programs will be essential. However, this entitlement reform alone will not get the job done. The federal government also needs to reprioritize and constrain other spending and consider whether revenues at the historical average of 18.3 percent of GDP will be sufficient—that may involve discussion of the

[27] In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.

tax system. I am pleased that GAO has been able to offer you specific analysis and tools to assist you in this important work. However, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and the fiscal clock is ticking.

The Federal Financial Reporting Model

The Financial Report provides useful information on the government's financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation's fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal challenge of the government—that is, the sustainability of the federal government's programs, commitments, and responsibilities in relation to the resources expected to be available.

The current federal financial reporting model does not clearly, comprehensively and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it does not provide the best possible picture of the federal government's overall performance, financial condition, and future fiscal outlook.

Accounting and financial reporting standards have continued to evolve to provide adequate transparency and accountability over the federal government's operations, financial condition and fiscal outlook. However, after 11 years of reporting at the governmentwide level, it is appropriate to consider the need for further revisions to the current federal financial reporting model, which could affect both consolidated and agency reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions:

- What kind of information is most relevant and useful for a sovereign nation?
- Do traditional financial statements convey information in a transparent manner?
- What is the role of the balance sheet in the federal government reporting model?

- How should items that are unique to the federal government, such as social insurance commitments and the power to tax, be reported?

In addition, further enhancements to accounting and financial reporting standards are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. For example, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include (1) a Statement of Fiscal Sustainability[28] that provides a long-term look at the sustainability of social insurance programs in the context of all federal programs, and (2) other sustainability information, including intergenerational equity.[29] The Federal Accounting Standards Advisory Board is currently considering possible changes to social insurance reporting and has initiated a project on fiscal sustainability reporting.

Engaging in a reevaluation of the federal financial reporting model could stimulate discussion that would bring about a new way of thinking about the federal government's financial and performance reporting needs. To understand various perceptions and needs of the stakeholders for federal financial reporting, a wide variety of stakeholders from the public and private sector should be consulted. Ultimately, the goal of such a reevaluation would be reporting enhancements that can help the Congress deliberate on strategies to address the federal government's challenges, including its long-term fiscal challenge.

Closing Comments

In closing, it is important that the progress that has been made in improving federal financial management activities and practices be sustained by the current administration as well as the new administration that will be taking office next year. Across government, financial management improvement initiatives are underway, and if effectively implemented, they have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. However, the federal government still

[28]The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

[29]Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

has a long way to go before realizing strong federal financial management. For DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses, but consistent and diligent management oversight toward achieving financial management capabilities, including audit readiness is needed. Federal agencies need to improve the government's financial management systems. The civilian CFO Act agencies must continue to strive toward routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis.

Addressing the nation's long-term fiscal challenge constitutes a major transformational challenge that may take a generation or more to resolve. GAO is committed to sustained attention to this fiscal challenge to help ensure that this is not the first generation to leave its children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring. Given the size of the projected deficit, the leadership and efforts of many people will be needed to put the nation on a more prudent and sustainable longer-term fiscal path.

Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current and future direction of vital federal government programs and policies are more difficult without such information. We will continue to stress the need for development of more meaningful financial and performance reporting on the federal government. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this subcommittee's leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact McCoy Williams, Managing Director; and Gary Engel, Director; Financial Management and Assurance at (202) 512-2600, as well as Susan Irving, Director; Federal Budget Analysis, Strategic Issues at (202) 512-9142. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual Basis Consolidated Financial Statements

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual basis consolidated financial statements. The federal government did not maintain adequate systems or have sufficient reliable evidence to support information reported in the accrual basis consolidated financial statements, as described below.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, 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 PP&E.

Without reliable 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 that 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.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies that account for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by certain federal credit agencies, certain deficiencies in the Department of Agriculture's credit reform processes contributed to its auditor being unable to obtain sufficient, appropriate evidence to support related accounts. As such, for fiscal year 2007, we have added this area to the list of material weaknesses contributing to our disclaimer of opinion on the accrual basis consolidated financial statements.

These issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Moreover, these weaknesses continue to adversely affect the federal government's ability to support annual budget requests for federal lending programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In the past, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. This year, the auditor's report on the financial statements that include the estimated military postretirement health benefits liabilities had not been issued as of the date of our audit report.[1] Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government's interests, were complete and properly reported.

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, weaknesses in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, if 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

The previously discussed material weaknesses in reporting assets and liabilities, material weaknesses 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

[1] The auditor's report on these financial statements was issued subsequent to the date of our audit report. The auditor continued to report issues related to the cost of direct health care provided by DOD-managed military treatment facilities.

government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2007 and 2006, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and Treasury's records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable 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. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in *The Budget of the United States Government* (hereafter referred to as "the President's Budget") concerning obligations and outlays.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

Preparation of Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2007, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). In addition, as discussed in our scope limitation section of our audit report, Treasury could not provide the final fiscal year 2007 accrual basis consolidated financial statements and adequate supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2007 audit, we found the following:

- Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.
- At the federal agency level, for fiscal year 2007, auditors for many of the CFO Act agencies reported material weaknesses or other significant deficiencies regarding agencies' financial reporting processes which, in turn, could affect the preparation of the consolidated financial statements. For example, auditors for several agencies reported that a significant number of adjustments were required to prepare the agencies' financial statements. These and other auditors are also required to separately audit financial information sent by the federal agencies to Treasury via a closing package. In connection with preparing the consolidated financial statements, Treasury had to create adjustments to correct significant errors found in agencies' audited closing package information.

- To make the fiscal years 2007 and 2006 consolidated financial statements balance, Treasury recorded net decreases of $6.7 billion and $11 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Other – Unmatched transactions and balances."[2] An additional net $2.5 billion and $10.4 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2007 and 2006, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- The federal government could not demonstrate that it had fully identified and reported all items needed to reconcile the operating results, which for fiscal year 2007 showed a net operating cost of $275.5 billion, to the budget results, which for the same period showed a unified budget deficit of $162.8 billion.

- Treasury's elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As previously discussed, amounts reported for federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. This resulted in the need for intragovernmental elimination entries by Treasury that recorded the net differences between trading partners as "Other – Unmatched transactions and balances," in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the accrual basis consolidated financial statements.

- We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that

[2]Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to net operating cost, it reported this amount as a component of net operating cost in the consolidated financial statements.

Treasury had not been reporting.[3] While Treasury made progress in addressing some of the remaining omitted information, there continue to be disclosures required by GAAP that are excluded from the consolidated financial statements. Also, certain material weaknesses noted in this report, for example, commitments and contingencies related to treaties and other international agreements, preclude Treasury from determining if a disclosure is required by GAAP in the consolidated financial statements and us from determining if the omitted information is material. Further, Treasury's ability to report information in accordance with GAAP will also remain impaired until federal agencies, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving inadequate or ineffective (1) documentation of certain policies and procedures; (2) management reviews of adjustments and key iterations of the financial statements, notes, and management discussion and analysis provided to GAO for audit; (3) supporting documentation for certain adjustments made to the consolidated financial statements; (4) processes for monitoring the preparation of the consolidated financial statements; and (5) spreadsheet controls.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, as we have reported in past years, there continue to be undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.

- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2007 financial reporting challenges it faced, such as weaknesses in Treasury's process for preparing the consolidated financial statements noted above. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication

[3]SFFAS No. 32, *Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"* (Washington, D.C.: Sept. 28, 2006).

to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. In addition, the federal government does not perform quarterly compilations at the governmentwide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year.

Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report a budget deficit for fiscal years 2007 and 2006 of $162.8 billion and $247.7 billion, respectively.[4] The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies' Statement of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit[5] reported in the consolidated financial statements. OMB and Treasury have continued to work with federal agencies to reduce these material unreconciled differences. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury's central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will be unknown.

In fiscal year 2007, we again noted that several agencies' auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary

[4]The budget deficit, receipts, and outlays amounts are reported in Treasury's Monthly Treasury Statement and the President's Budget.

[5]See GAO's audit report on its audit of the federal government's fiscal year 2006 financial statements that was incorporated in the *2006 Financial Report of the U.S. Government* published by Treasury. Also, see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).

transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses also affect the agencies' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its Combined Statement of Receipts, Outlays, and Balances,[6] and certain amounts reported in the President's Budget.

[6] *Treasury's Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.

Appendix II: Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2007. In addition to the material weaknesses discussed in appendix I that contributed to our disclaimer of opinion on the accrual basis consolidated financial statements, we found the following three other material weaknesses in internal control.

Improper Payments

Although showing progress under OMB's continuing leadership, agencies' fiscal year 2007 reporting under the Improper Payments Information Act of 2002 (IPIA)[1] does not reflect the full scope of improper payments. For fiscal year 2007, federal agencies' estimates of improper payments, based on available information, totaled about $55 billion.[2] The increase from the prior year estimate of $41 billion[3] was primarily attributable to a component of the Medicaid program reporting improper payments for the first time totaling about $13 billion for fiscal year 2007, which we view as a positive step to improve transparency over the full magnitude of improper payments.

Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.[4] For fiscal year 2007, four agency auditors reported noncompliance issues with IPIA related to agencies' risk assessments, sampling methodologies, implementing corrective action plans, and recovering improper payments. We also identified issues with agencies' risk assessments such as not completing risk assessments of all programs and activities or not conducting annual reviews of any programs

[1]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002). The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments, estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments.

[2]The $55 billion includes 19 newly reported programs with improper payment estimates totaling about $16 billion. Of the 19 programs, 5 reported zero improper payment estimates for fiscal year 2007.

[3]In their fiscal year 2007 Performance and Accountability Reports (PAR), selected federal agencies updated their fiscal year 2006 improper payment estimates to reflect changes since issuance of their fiscal year 2006 PARs. These updates decreased the governmentwide improper payment estimate for fiscal year 2006 from $42 billion to $41 billion.

[4]GAO, *Improper Payments: Agencies' Efforts to Address Improper Payment and Recovery Auditing Requirements Continue*, GAO-07-635T (Washington, D.C.: Mar. 29, 2007).

and activities. OMB's current guidance allows for annual risk assessments to be conducted less often than annually (generally every 3 years) for programs where baselines are already established, are in the process of being measured, or are scheduled to be measured by an established date. For fiscal year 2007, we noted that 4 agencies were implementing a 3-year cycle for conducting risk assessments. Furthermore, select agencies have not reported improper payment estimates for 14 risk-susceptible federal programs with total program outlays of about $170 billion for fiscal year 2007. Lastly, we found that major management challenges and internal control weaknesses continue to plague agency operations and programs susceptible to significant improper payments. For example, in the Department of Education's fiscal year *2007 Performance and Accountability Report*, the Office of Inspector General reported that its recent investigations continue to uncover problems, including inadequate attention to improper payments and failure to identify and take corrective action to detect and prevent fraudulent activities by grantees.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place 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. GAO has reported information security as a high-risk area across government since February 1997. During fiscal year 2007, federal agencies did not consistently implement effective controls to prevent, limit, or detect unauthorized access to computing resources. Specifically, agencies did not always (1) identify and authenticate users to prevent unauthorized access; (2) enforce the principle of least privilege to ensure that authorized access was necessary and appropriate; (3) apply encryption to protect sensitive data on networks and portable devices; (4) log, audit, and monitor security-relevant events; and (5) restrict physical access to information assets. In addition, agencies did not consistently configure network devices and services to prevent unauthorized access and ensure system integrity, such as patching key servers and workstations in a timely manner; assign incompatible duties to different individuals or groups so that one individual does not control all aspects of a process or transaction; and maintain or test continuity of operations plans for key information systems. Such information security control weaknesses unnecessarily increase the risk that the reliability and availability of data that are recorded in or transmitted by federal financial management systems could be compromised. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The administration has taken important actions to improve information security, such as issuing extensive guidance on information security and requiring agencies to perform specific actions to protect certain personally identifiable information. However, until agencies effectively and fully implement agencywide information security programs, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2007, material internal control weaknesses and systems deficiencies continued to affect the federal government's ability to effectively manage its tax collection activities, an issue that has been reported in our financial statement audit reports for the past 10 years. Due to errors and delays in recording taxpayer information, payments, and other activities, 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. Moreover, the federal government did not have cost benefit information, related cost-based performance measures, or a systematic process for ensuring it is using its resources to maximize its ability to collect what is owed and minimize the disbursements of improper tax refunds. 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.

Appendix III: Fiscal Year 2007 Audit Results

Table 2: CFO Act Agencies: Fiscal Year 2007 Audit Results and Principal Auditors

CFO Act agencies	Opinion rendered by agency auditor	Agencies' auditors reported material weaknesses or noncompliance[a]	Principal auditor
Agency for International Development	Unqualified		OIG
Agriculture	Qualified	√	OIG
Commerce	Unqualified	√	KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young, LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified		Pricewaterhouse Coopers LLP
Health and Human Services	Unqualified	√	Pricewaterhouse Coopers LLP
Homeland Security	[b]	√	KPMG LLP
Housing and Urban Development	Unqualified	√	OIG
Interior	Unqualified	√	KPMG LLP
Justice	Unqualified		KPMG LLP
Labor	Unqualified	√	KPMG LLP
National Aeronautics and Space Administration	Disclaimer	√	Ernst & Young, LLP
National Science Foundation	Unqualified		Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified	√	R. Navarro & Associates, Inc.
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		Pricewaterhouse Coopers LLP
State	Disclaimer	√	Leonard G. Birnbaum and Company, LLP
Transportation	Unqualified	√	OIG
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP

Source: GAO.

[a]Reported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

[b]For fiscal year 2007, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit; the auditor was unable to express an opinion on these two financial statements.

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Mr. TOWNS. Mr. Werfel.

STATEMENT OF DANIEL WERFEL

Mr. WERFEL. Thank you. Thank you, Chairman Towns, Ranking Member Bilbray, Representative Welch and other members of the subcommittee for having this hearing today and inviting me to speak.

When the CFO Act of 1990 was enacted close to 18 years ago, Congress established three fundamental objectives for Federal financial management. The first objective was transparency, making sure that the Federal Government is informing the public on the state of the Nation's finances. The second objective was internal control, making sure that Federal agencies were putting in the right people, process and technology to track Federal taxpayer funds and mitigate financial risks. And the third objective was decision support, making sure that the right financial information at the right time was in the hands of agency decisionmakers to guide both operational, programmatic and other key decisions of the Federal Government.

Through improvements in the reliability and timeliness and readability of our financial report, we are building a foundation for achieving the broader objectives of the CFO Act.

With respect to reliability, 80 percent of CFO Act agencies today have clean audit opinions, and governmentwide we have seen 4 consecutive years of declines in material weaknesses, with an overall decrease of 35 percent in the last 7 years.

With respect to the timeliness of our financial report, agencies are now reporting audited financial statements 45 days after the end of the fiscal year and the governmentwide report comes out 30 days after that. Compare that with just not so long ago, several years ago, when the timelines for producing these reports were more than 3 months more than what I just described.

And with respect to the readability and the transparency of our financial reports, through an OMB pilot program conducted in 2007, agencies are producing summary documents to help readers digest hundreds of pages of detailed information on finance and performance.

Attached to my testimony today—and Mr. Dodaro mentioned it as well—is a great example of how we're working to make government financial reports more transparent. This report, A Citizen's Guide to the 2007 Financial Report to the U.S. Government, provides readers with an 8-page version of the larger 182-page financial report. It is an easy-to-read overview of the U.S. Government's short and long-term financial outlook, and it serves as an important reference tool for data and findings of that 182-page document I referenced earlier.

We are very proud of the citizen's report not only because it improves the presentation of our financial information. We are proud because of the clarity and transparency this report gives to the most significant fiscal challenges facing the government today and that is, as very astutely described by Mr. Dodaro, the impending, unprecedented and enormous fiscal imbalance the Federal Government faces due to the rising cost of entitlement programs.

The Federal financial community plays an important role with respect to this fiscal crisis.

First, the Federal financial community is responsible for ensuring that the data and analysis are clearly and effectively communicated to the public and to the policymakers. We believe the Citizen's Guide is an important step in meeting this objective.

And also, as has been mentioned already, our attainment of a clean opinion on the Statement of Social Insurance is another critical step, because it demonstrates not only that we are reporting the information clearly but the information contained within this important report is reliable.

The Federal financial community is responsible for more than just reporting on the Nation's fiscal health. It plays a critical role in developing and implementing strategies to control Federal spending and otherwise ensure that the fiscal health of the Federal Government remains sound. In areas such as improper payments, billions of dollars in error are being eliminated; and real property, billions of dollars in unneeded assets, are being removed from our inventory. The Federal community is achieving these results by gathering reliable financial data, just as the CFO Act originally envisioned, and using that data to make smarter decisions about the way government funds are spent.

Despite these results, there is clearly more work to be done. While most of our major financial reports are passing audit scrutiny, too many of them do not. To address this, we do have sound corrective action plans in place for each financial management weakness, and these action plans continue to have us trending toward better audit results each year. With the unprecedented challenge before us on the future fiscal health of the government, we need to make sure that our financial readers are moving beyond just the fundamentals of audited financial statements. We need to make sure our financial reports contain the right information that is most relevant to the important programmatic and business decisions that agencies make, and we also need to make sure that the internal control requirements that we impose on Federal agencies are sufficiently focused on financial risks, such as improper payments and charge card abuses.

As we approach the 20-year anniversary of the CFO Act, OMB looks forward to working with Congress and GAO to evaluate financial management requirements as they exist today, to address the issues about I have outlined and to ensure that the broad and important objectives of the act are met.

At this time, I'm happy to answer any questions that you have.

Mr. TOWNS. Thank you very, very, very much.

[The prepared statement of Mr. Werfel follows:]

Testimony of Daniel I. Werfel
Deputy Controller
Office of Management and Budget

before the

Subcommittee on Government Management, Organization, and Procurement
House Committee on Oversight and Government Reform

June 5, 2008

With the rising cost of entitlement programs expected to create an unprecedented and enormous fiscal imbalance for the Federal Government in the coming decades, achieving our financial management goals is more critical today than any other time in our nation's history. The financial management community is not only responsible for reporting on the extent and nature of our fiscal challenges, it also plays a critical role in developing and implementing strategies to control Federal spending and otherwise ensure that the fiscal health of the Federal Government remains sound.

We must ensure that the Federal financial community is well positioned to meet these challenges. Clear financial management goals are in place, including the attainment of clean financial statement audit opinions[1], elimination of material weaknesses in internal controls[2], issuance of timely financial reports, disposal of unneeded real property, and the elimination of improper payments. To build on the recent and unprecedented results achieved by Federal agencies in each of these areas, Federal managers must:

- strengthen accounting practices in high-risk areas such as inventory and fund balances;
- strengthen internal controls in areas where mission and organizational risks are highest;
- issue more transparent, readable, and relevant financial reports for both public stakeholders and agency decision-makers; and
- improve the integrity and accuracy of Federal payments and eliminate other forms of waste, such as the misuse of government charge cards.

In addition, the Office of Management and Budget (OMB), the Government Accountability Office (GAO), and Congress must work together to ensure that the financial management requirements we impose on Federal agencies strike an appropriate balance between the costs of agency efforts with the benefits they ultimately deliver for the taxpayer. The approaching twenty-year anniversary of the Chief Financial Officers (CFO) Act of 1990 provides an opportunity for a thorough evaluation of the current legislative and regulatory requirements and identification of alternative approaches that improve the value of Federal financial activities.

[1] A clean audit opinion serves as an indicator that the financial statements of that Federal department or agency are reliable and can be depended upon to communicate the true nature of that department's/agency's financial position.
[2] A material weakness occurs when the underlying processes and systems supporting the financial statements do not adequately mitigate the risk of presenting unreliable and flawed financial information.

Status of Federal Agency Financial Reporting

In fiscal year (FY) 2007, Federal agencies improved the readability, validity, and timeliness of their financial information. To enhance readability, OMB conducted a pilot where participating agencies explored different formats for enhancing the presentation of financial and performance information contained in their consolidated Performance and Accountability Reports (PAR). One of the more successful products of the pilot was a "Highlights" document that contained performance and financial information in a brief, user-friendly format. We intend to make further improvements to the pilot in FY 2008 by initiating a three-tiered reporting structure:

- A two-page summary that provides the reader with a quick snapshot of agency results;
- A 25-page Citizens' Report that, while still a summary, provides a more comprehensive view of agency mission, key goals, how funds are spent, performance relative to goals, and actions they plan to take to build on successes or address shortcomings; and
- The comprehensive PAR, which provides exhaustive and complete details on relevant financial and performance data.

Federal agencies are also making progress in improving the reliability and timeliness of the financial information being reported. Specifically, the following results were achieved in FY 2007:

- Of the 24 major Federal agencies, 80 percent received clean audit opinions.
- For the third consecutive year, all major Federal agencies issued their audited financial statements 45-days after the end of the fiscal year, compared to the previous five month (150 days) reporting deadline.
- The total number of material weaknesses government-wide declined from 41 to 39. This is the fourth year in a row that material weaknesses have declined, with a more than 35% decrease in weaknesses since 2001.
- Five additional agencies received a clean audit opinion with no material weaknesses which brings the total number of agencies realizing this important accomplishment to 13, up from just seven in 2001.[3]

To ensure that all agencies are on a path to financial management excellence, we continue to monitor Federal agencies' progress in eliminating material weaknesses and improving other critical financial management processes. OMB works with the Department of Defense, the Department of Homeland Security and other agencies with significant financial management challenges to ensure that they are making steady progress on sound corrective action plans with clear goals and milestones for success. Even so, several areas continue to pose accounting challenges for agencies including fund balance with Treasury,[4] property, plant, and equipment,

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[3] The thirteen agencies are the Departments of Justice, the Interior, Energy, Commerce, Education, Labor, the Small Business Administration, the Environmental Protection Agency, the General Services Administration, the National Science Foundation, the Office of Personnel Management, the Social Security Administration, and the U.S. Agency for International Development.

[4] Similar to checking accounts at banks, the Agencies' Fund Balance with Treasury accounts represents the status of funds agencies have with the U.S. Treasury for which they are authorized to make payments against (i.e. the net effect of all collections and disbursements).

and inventory. The proper accounting and reporting of this financial information enables agencies to better manage costs and resources for accomplishing their programs and mission. Further, it provides a clear and reliable picture of the agencies' fiscal health to the Congress, public, and other stakeholders.

Status of Government-Wide Financial Reporting

Over the past several years, OMB and the Treasury Department have made progress in improving the reliability and readability of the Financial Report of the United States Government ("Financial Report"). The Financial Report aggregates financial information from individual Federal agencies and reports the financial statements for the Federal government as a whole, including the government-wide balance sheet[5] and the Statement of Social Insurance (SOSI).[6] Because the Financial Report is one of the primary government reports providing information on the long-term fiscal impacts of rising entitlement costs, it is a top priority of OMB and the Treasury Department to ensure the public can both understand and trust the information contained in the Financial Report.

Similar to the "Highlights" documents created by agencies under the PAR pilot, OMB and the Treasury Department issued a summary version of the Financial Report for the first time in FY 2007. *The Government's Financial Health: A Citizen's Guide to the 2007 Financial Report of the United States Government*[7] provides readers an eight-page version of the larger, 182-page Financial Report. The Citizen's Guide is an easy to read overview of the U.S. government's short-term and long-term financial outlook and serves as a reference tool for key data and findings in the Financial Report.

This past year, an important milestone was also achieved regarding the reliability of the information contained in the Financial Report – a clean audit opinion on the SOSI. The SOSI is the first of the six principal financial statements to achieve this milestone. This statement, along with the Fiscal Stewardship discussion, are the Report's primary sources for information on the long-term fiscal impact of Medicare and Social Security costs.

OMB and the Treasury Department are making important progress toward achieving a clean audit opinion on the remaining statements and addressing concerns raised by GAO in its audit of the Financial Report. GAO has identified three critical areas for improvement – eliminating intra-governmental imbalances, improving the process for preparing and consolidating the Financial Report, and working with the Department of Defense to ensure that its net cost of operations and material items on the agency's balance sheet, such as inventory, fund balance with Treasury, and environmental liabilities are reliable and ready for audit. Progress is being

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[5] The balance sheet is a financial statement that depicts what is owned (assets) and owed (liabilities) by the reporting entity.

[6] The Statement of Social Insurance is a financial statement that depicts the long-term sustainability of social insurance programs by comparing the projected inflows (taxes and other contributions) and outflows (benefit payments) of those programs.

[7] The Citizens Guide to the Financial Report is available at http://www.fms.treas.gov/frsummary/frsummary2007.pdf. A copy of the Citizen's Guide is also attached to this testimony.

made in each of these areas, including OMB's implementation of an intra-governmental "watchlist" where agencies worked together in FY 2007 to resolve more than half of the $24 billion in unreconciled items included on the original watchlist.

Other Initiatives and Focus Areas

Improvements in financial reporting often translate into measurable results in improving the way the government is managed and taxpayer monies are spent. These benefits are most evident in the areas of improper payments, real property, and charge cards. OMB often refers to these as "areas of public trust" as they serve as a critical indicator for citizens to gauge how well the Federal government is acting as a steward of taxpayer dollars.

Reducing Improper Payments

In the four years of reporting under the Improper Payment Information Act of 2002, the Federal government has demonstrated measurable improvements in reducing improper payments. Notably, the error rate for programs first reporting in FY 2004 declined from 4.4 percent to 3.1 percent (a $7.9 billion reduction) in FY 2007 and programs first reporting error rates in FY 2005 and 2006 cut improper payments in half by FY 2007 (a $2.3 billion reduction). To ensure continued success, OMB has proposed a series of legislative reforms that, in total, would generate an estimated $18 billion in error reduction and savings over 10 years. We applaud the Congress for taking the first step toward enacting some of these key reforms by including discretionary funding (above the "cap") for activities with a proven track record of reducing error and generating program savings in the most recent budget resolution. It will be important for Congress to ensure that these activities are funded in the final FY 2009 appropriations bills and that other legislative proposals for reducing error are enacted.

Managing Federal Real Property

In February 2004, the President issued Executive Order (E.O.) 13327, "Federal Real Property Management" to improve oversight of the $1.5 trillion in Federal assets. E.O. 13327 is designed to hold agencies accountable for maintaining their real property portfolios at the right size, right condition and right cost. As of December 2007, agencies had disposed of $7 billion worth of unneeded assets, making significant progress towards meeting the government-wide goal of disposing $15 billion by fiscal year 2015. However, legislative reform is critical if we are to continue to make progress in this area. As I testified before this Subcommittee in April, we applaud and support Congress' effort to enact real property reform through the introduction of H.R. 5787. This bill would provide a financial incentive for agencies to dispose unneeded assets and provide funding for agencies to invest in repairing and maintaining existing assets, an important step towards addressing the billions in repair backlog as reported by the GAO.

Ensuring Proper Charge Card Use

More than 3.1 million charge cards are in use today across the Federal Government. In FY 2007 alone, more than $27 billion was spent using these charge cards to purchase goods and services, pay for government employee travel and travel-related expenses, and to acquire fuel and maintenance services for government vehicles, aircraft, and other equipment. Overall, the Charge Card Program has resulted in approximately $1.8 billion in annual savings compared to the prior, paper-based, procurement processes. However, a recent GAO report (GAO-08-333) was published highlighting instances of misuse of the Federal charge card. This is a very serious issue that breaches the trust of the taxpayers as well as diminishes the significant benefits that are achieved through the Federal charge card program. OMB is in the process of updating its guidance (Appendix B to Circular No. A-123) to address the GAO findings. However, we believe misuse of the Federal charge card is the exception rather than the rule, and most Federal employees are using government charge cards responsibly.

Looking Ahead

When the CFO Act of 1990 was enacted close to 18 years ago, Congress established three fundamental objectives for Federal financial management:

(1) ***Transparency*** – effective reporting of agency finances to the public, including information on the sustainability of government operations and a user-friendly presentation of the cost effectiveness of government programs.
(2) ***Targeted Internal Controls*** – policies and procedures that mitigate the most significant areas of financial risk in the organization.
(3) ***Decision Support*** – personnel at all levels in the organization with financial information to manage risk and drive better program results.

To lay a foundation for these objectives, the Act required Federal agencies to annually publish audited financial statements and established the position of agency CFO to lead these efforts. As exemplified by results achieved in FY 2007, the Federal CFOs have come a long way towards putting this foundation in place. However, much work remains as the Federal financial community moves beyond the fundamentals of audited financial statements to achieving the broader objectives of the Act.

Transparency. In the realm of public reporting, the Citizen's Guide and the PAR pilot represent an important first step in improving the readability of our financial reports. In addition, OMB is working with the Treasury Department, GAO, and the Federal Accounting Standards Advisory Board to refine and improve reporting on the impending fiscal challenges brought on by growing entitlement costs. Specifically, a new financial statement for the Financial Report is under development that would expand on current information in the SOSI, providing a comprehensive picture of fiscal sustainability.

Targeted Internal Controls. Through the revisions to the OMB Circular No. A-123, Management's Responsibility for Internal Control and the creation of its Appendix A that is specific to the internal controls over financial reporting, agencies have implemented a more rigorous assessment process and devoted resources to testing and correcting deficiencies in internal control over financial reporting. This process has yielded favorable results within Federal agencies. As we look for additional opportunities to further improve financial management, we plan to explore possibilities for leveraging the Appendix A framework for financial reporting to focus on other significant risk areas (e.g., programmatic, mission, administrative) within Federal agencies and government-wide.

Decision Making. As agencies continue to improve their internal controls to support timely and reliable financial information and report that information in the most transparent and digestible format, we also need to ensure that the financial information is relevant and available to Federal managers for day-to-day decision making. While the private and public sectors continue to debate the utility and format of financial statements, the underlying financial information and fiscal disciplines to produce those statements should remain constant. We need to explore opportunities in this area to ensure that the underlying financial information and fiscal disciplines are sound, appropriate, and flexible to not only produce external financial statements, but to also provide relevant financial information to allow Federal leaders to more efficiently manage the day-to-day operations of the government.

As we approach the 20^{th} anniversary of the CFO Act, it is evident that we have come a long way. But we should not stop here. Every tax dollar is too precious not to make well-informed decisions. We will continue to seek opportunities, look at the tools in place for financial reform, and refine the path we are taking as necessary. We look forward to continuing our partnership with Congress and the Government Accountability Office in pursuing fiscal health by holding agencies accountable, improving financial management, addressing our long-term fiscal challenges, and striving for stronger, smarter, and sustainable accountability.

Attachment

The Government's Financial Health: A Citizen's Guide to the 2007 Financial Report of the United States Government

http://www.fms.treas.gov/frsummary/frsummary2007.pdf

Mr. TOWNS. Mr. Patterson, good to see you again.

STATEMENT OF J. DAVID PATTERSON

Mr. PATTERSON. Good to see you, Mr. Chairman.

Mr. Chairman, Ranking Member Bilbray and Congressman Welch, thank you for this opportunity to appear before you to discuss the Department's financial management improvement efforts and to respond to your questions. We are always happy to bring to the committee an update and to clarify any questions you might have on specific issue areas.

With me today, I'd like to introduce Mr. James Short, Deputy Chief Financial Officer, and Mr. David Fisher, Director of the Business Transformation Agency, who will be pleased to answer questions relating to the—would you please stand, please?

Mr. TOWNS. Thank you.

Mr. PATTERSON. And they will be pleased to answer questions that are specific to the topics you identified in your letter of invitation.

Before we address the particular issue areas, however, I would like to discuss just a moment two most important aspects of DOD financial management, the size and scope of the challenge we face, and, second, the progress that the Department has been making in meeting that challenge over the last 7 years.

The Department of Defense is not only the largest Department in the Federal Government, it is the largest and most complex organization in the world, with more than 600,000 facilities, 6,000 locations, 163 countries around the globe. The Department has 5.2 million inventory items, $3.6 trillion in assets and liabilities and an operating budget this year that exceeds half a trillion dollars.

To put this in perspective, consider the Department's annual base budget is almost 50 percent greater than the annual revenues of Wal-Mart, its assets three times the size of Wal-Mart, IBM and ExxonMobil combined. In fact, the Department of Defense, if it were a country, it would rank 17th among the world's GDPs.

In a single year, the Department of Defense processes more than 150 million pay transactions, which is approximately 22 pay transactions every second on a 40-hour workweek—disbursed is over $446 billion to payroll recipients, commercial vendors—manages $22 billion in foreign military sales and maintains about 57 million general ledger accounts.

But the Department's sheer size and magnitude and complexity is not in any way an excuse for not putting every available resource and all of our energies into ensuring America's hard-earned tax dollars are spent wisely. Quite to the contrary. It is, however, an explanation why achieving our financial management objectives is not a quick and easy matter.

The second point is the substantial progress that the Department has made over the last 7 years in bringing its financial management processes and systems into the 21st century and preparing the Department for that clean audit. For example, in 2001, only two DOD entities, the Department of Finance and Accounting Service and the Military Retirement Fund, were auditable. Today, we have five defense entities whose combined assets and liabilities comprise 15 percent of the Department's total assets and 50 percent of its total liabilities. They all have clean audit opinions.

Again, to give you some perspective, the combined value of those five entities is larger than the value of the entire Department of Health and Human Services, which is the next largest Federal agencies with an unqualified audit opinion.

By the end of fiscal year 2009, we expect to receive clean audit opinions on 37 percent of the Department's total assets and 88 percent of its liabilities and that by 2010 48 percent of all DOD assets and 89 percent of all of its liabilities will be audit ready. In addition, the U.S. Army Corps of Engineers, which accounts for $49 billion in DOD assets and liabilities, was audited for the first time and is projected to receive a clean audit in the next fiscal year.

So we have some tremendous progress and we have made a tremendous amount of progress in these last short few years, but improved financial management is also eliminating material weaknesses, increasing efficiency and productivity and saving the taxpayers literally billions of dollars. For example, financial transformation, combined with robust metrics programs, has produced a dramatic 80 percent improvement in the accuracy and timeliness of information. Electronic invoicing has reduced errors and increased efficiencies, raising the number of electronic invoices processed per quarter of 64 percent in 2004 to 82 percent today.

Since 2001, 84 percent of all manager-identified internal control weaknesses have been corrected, dropping from 116 to just 19. In addition, increases in the rate of operations and elimination of excess capacity and increased productivity at DEFAS by 52 percent while lowering costs to the services by $317 million has occurred since 2001. Military and civilian pay is now more than 99 percent accurate. At Defense Contract and Audit Agency, which audits more than 10,000 contractors, including some of the world's largest companies, more than 271,900 audits have taken place since 2001, covering $1.9 trillion. These audits have saved the taxpayers $17.6 billion.

Mr. Chairman, these are just a few examples of how the Department of Defense has transformed financial management and put the Department on a clear path to a clean audit.

Again, we are happy to be here, and I'm very pleased to take your questions, sir.

Mr. TOWNS. Thank you very much.

[The prepared statement of Mr. Patterson follows:]

Testimony of

Mr. J. David Patterson
Principal Deputy Under Secretary of Defense (Comptroller)

before the

House Committee on Oversight and Government Reform
Subcommittee on Government Management, Organization and Procurement

June 5, 2008

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Subcommittee on Government Management, Organization and Procurement

Mr. Chairman, Members of the Committee, thank you for the opportunity to appear before you today to discuss the Department's financial management improvement efforts, and to respond to your questions. We are always happy to bring the Committee up-to-date, and to clarify any questions you may have about specific issue areas.

Indeed, with me today are Mr. James Short, Deputy Chief Financial Officer, and Mr. David Fisher, Director of the Business Transformation Agency, who will be pleased to answer questions relating to the specific topics identified in your letter of invitation.

Before we address particular issue areas, however, I would like to discuss what I consider to be the two most important aspects of DoD financial management: First, the size and scope of the challenge we face; and second, the progress the Department has made in meeting that challenge over the last seven years.

First, size: The Department of Defense is not only the largest department in federal government, it is largest and most complex organization in the world – perhaps the largest in the history of the world.

With more than 600,000 facilities in 6,000 locations and 163 countries around the globe, the Department of Defense has more than 5,600 IT systems, 5.2 million inventory items, \$3.6 trillion in Assets and Liabilities, and an operating budget that exceeds half a trillion dollars.

To put that in perspective, consider that the Department's annual base budget is almost 50 percent greater than the annual revenues of Wal-Mart; its assets, three times the size of Wal-Mart, IBM and Exxon Mobil combined. In fact, if the Department of Defense were a country, it would rank 17th among the economies of the world.

In a single year, the Department of Defense processes more than 154 million pay transactions – or approximately 22 transactions every second; disperses over \$446 billion to payroll recipients and commercial vendors; manages \$22 billion in foreign military sales; and maintains about 57 million general ledger accounts – which also makes it the world's largest financial entity, and the largest entity ever to be audited end-to-end.

Having said that, the Department's sheer size and complexity is not, in any way, an excuse for not putting every available resource and all of our energy into ensuring that American's' hard-earned tax dollars are wisely spent; quite the contrary. It is, however, the reason why achieving our financial management objectives is not a quick or easy matter.

So that's the first point. The Department of Defense is a huge enterprise that, for decades before the age of networked information, utilized an outmoded collection of financial systems that were not only incompatible with each other, but also with the modern world.

The second point is the substantial progress the Department has made over the last seven years in bringing its financial management processes and systems into the 21st century, and preparing the Department for audit.

For example, in 2001, only two DOD entities – the Defense Finance and Accounting Service, and the Military Retirement Fund – were auditable. Today, five Defense entities, whose combined assets and liabilities comprise 15 percent of the Department's total assets and 50 percent of its total liabilities, have clean audit opinions.

Again, to give you a bit of perspective, the combined value of those five entities is larger than the value of the entire Department of Health and Human Services, the next largest federal agency with an unqualified audit opinion.

By the end FY 2009, we expect to receive clean opinions on 37 percent of the Department's total assets, and 88 percent of its total liabilities; and that by 2010, 38 percent of all DoD assets and 89 percent of all liabilities will be audit ready.

In addition, the US Army Corps of Engineers, which accounts for $49 billion in DoD assets and liabilities, was audited for the first time, and is projected to receive a clean audit in the next fiscal year. So, we have come a tremendous way in a few short years.

Improved financial management is also eliminating material weaknesses, increasing efficiency and productivity, and saving the taxpayers, literally, billions of dollars. For example, financial transformation, combined with a robust metrics program, has produced a dramatic 80 percent improvement in the accuracy and timeliness of information. Electronic invoicing has reduced errors and increased efficiency, raising the number of electronic invoices processed per quarter from 64 percent in 2004 to 82 percent today. Amounts owed the Department from the public dropped 42 percent since December 2005. Paying invoices on time has avoided $247 million in interest penalties since 2001; and since 2001, 84 percent of all manager-identified internal control weaknesses have been corrected, dropping from116 to just 19.

In addition, increases in the rate of operations and the elimination of excess capacity has increased productivity at DFAS by 52 percent while also lowering costs to the Services $317 million since 2001. Inaccurate accounting records, which increase the risk of fraudulent transactions, have been reduced by more than 96 percent; accounts used by base commanders to manage funds now have a 100 percent reconciliation balance with Treasury; and military and civilian pay is now more than 99 percent accurate.

At the Defense Contract Audit Agency, which audits more than 10,000 contractors – including some of the world's largest companies – every year, more than 271,900 audits, covering $1.9 trillion, were performed from 2001 to 2007. These audits saved taxpayers $17.6 billion.

Mr. Chairman, these are just a few examples of how the Department of Defense has transformed financial management and put the Department on a clear path to a clean audit. There are many, many more. But the important thing to remember is 1) We have taken the largest and most complex organization in the world; and 2) put in place a solid financial management plan that's working – increasing efficiency and productivity, providing accountability, and just as importantly, transparency, and saving the taxpayers billions of dollars every year.

Finally, Mr. Chairman, I want you to know that every DoD official – from the Secretary of Defense, to agency heads, to military leaders – is committed to wise stewardship of resources and sustained modernization that supports, not the bureaucracy, but our global defense mission, and the brave men and women who put their lives on the line every day to carry it out.

Mr. Chairman, thank you again for the opportunity to be with you today. We look forward to your questions.

Mr. TOWNS. I know you know that the bells have sounded, and that means that we have votes. So what I'm going to do is to call for a recess until 3:30, and then we'll come back and we'll have some questions for you. Because there are about five votes, and I understand it will probably be 3:30 before we will be free. I hate to do this, but we have to vote. So we will be back at 3:30.

So the committee is in recess.

[Recess.]

Mr. TOWNS. We'll come to order.

Again, let me apologize for the delay, but voting is important around here.

Let me begin with you, Mr. Dodaro. Your report emphasizes the long-term financial problems that the Federal Government is going to have with meeting all of its commitments as the baby boomers' generation reaches retirement. The report says we are on an imprudent and unsustainable fiscal path and calls for leadership to place us on a more prudent path. As you know, your predecessor, David Walker, presented a list of proposals last year that he said would help us get back on such a path. Does GAO continue to support those proposals?

Mr. DODARO. First of all, we continue to be very concerned about the long-term fiscal path. I think the proposals that Mr. Walker had advanced are very important considerations that need to be, you know, continued to be debated and discussed. And so, you know, basically, we think several things, Mr. Chairman.

First, there needs to be attention to reforming the entitlement programs, in particular in the health care area—health care is the primary driver of the long-term fiscal condition—but also Social Security reform.

We think there needs to be also, you know, additional looks at the budget process that is in place with trying to provide more transparency about the long-term implications of various proposals and the government's financial condition. We are very encouraged by the inclusion in the fiscal report of the long-term fiscal position. And, as Mr. Werfel pointed out, the summary report available to all citizens talks about the unsustainable path; and these debates need to be continued. We think there is a need for long-term sustainability reporting on the Federal Government and additional tools that are available to alert policymakers to the long-term implications.

So, you know, by and large, the ideas that former Comptroller General Walker advanced are still relevant and need to be continued to be discussed and hopefully addressed as we move forward.

Mr. TOWNS. What can we do to increase public awareness and understanding of this problem?

Mr. DODARO. Well, I think the first thing was the summary annual report that has been made available this year. I think that is very important for the public to understand.

I know one of the reasons that Mr. Walker resigned as Comptroller General was to continue the public awareness and education campaign through the new foundation that was created that he is heading up as chief executive. We plan at GAO to continue to make this a prominent piece of the reports and testimonies that we have. We have a Web site, Mr. Chairman, that we update these long-term projections on a quarterly basis, and it is available to all members of the public. So GAO will continue within the sphere of our independent and nonpartisan status to keep raising this issue both to the attention of the Congress but also, you know, indirectly to the public through our reports and testimonies.

Mr. TOWNS. Right.

Mr. Werfel, what do you think could be done?

Mr. WERFEL. I agree a lot with Mr. Dodaro.

I think, first of all, the efforts of David Walker and the various foundations that are driving a fiscal wake-up tour—I think, they have been to 40 different cities around the Nation, really with a powerful presentation on the fiscal imbalance that is upon us, using graphs like what Mr. Dodaro provided, and trying in a really digestible, user-friendly way to explain what is happening with respect to the growth and entitlement costs and how it is going to impact citizens and the children and grandchildren of citizens. And the Federal financial community more and more is taking seriously the need to get this information out there in a digestible way and make sure that folks like you on the Hill and the media and others are paying very close attention to it.

I know the President's budget spends many, many pages on this issue trying to explain the level of the urgency, and this report tries to do it in a little bit more of a simple and easy-to-digest framework than is in both the financial report and the President's budget. But I think the fiscal wake-up tour is an important first step, and I think, from our perspective, the more clarity we can provide to the issue—that is the best first step question take.

Mr. TOWNS. At this time, I yield to the ranking member.

Mr. BILBRAY. I guess, Mr. Chairman, everybody is talking about, you know, climate change and the issue of An Inconvenient Truth. I guess, from the fiscal point of view, we are talking about a terrifying truth, and I wish as much attention was given to that. Maybe we need somebody to do a movie to scare the hell out of the public with what kind of fiscal reality we are giving our grandchildren and our great grandchildren.

Gene, you were talking about the issue of reaching a debt limit and having to move it again. Do we have any plan not to dig the hole deeper so we don't bottom out? Do we have any plan to avoid having to ask Congress not to raise the debt limit?

Mr. DODARO. Actually, Congressman, the debt limit indication is really a lag indicator. By the time that happens, the commitments and the spending have already occurred, and that is why we're trying to encourage some, you know, forward thinking about the implications going forward. And also, Congressman, by the way, there is a movie in the making, and it is one of Mr. Walker's projects going forward to try to——

Mr. BILBRAY. Well, I hope I get a footnote for the title. OK?

Mr. DODARO. OK. But in terms of the debt limit, I mean, given the commitments and the spending that is—the decisions that are going to be made this year, I think it is pretty much, you know, a predictable that next fiscal year it is going to happen. So, I mean, all the debt limit does in raising a bit is to allow for past commitments that have already been made to be issued.

You know, one of the issues that we have, you know, raised is that a lot of spending now, a greater proportion of Federal spending, is on mandatory spending, which is governed by law. So as long as the eligible populations meet that criteria, the money gets spent, and so there is less on a discretionary basis. So to the extent to which eligible people receive those services—the Federal Government is obligated to pay it.

Mr. BILBRAY. So it is really easy for us to make all these commitments, and then take all of the credit for it but then bail out and not have to pay the bill?

Mr. DODARO. The bills come, and they will have to be—the money will have to be raised in order to pay the bills. And that will come. I mean——

Mr. BILBRAY. Just as we are talking about the fact that the existing politics, economy and cultural experience is going to leave a devastated planet to our next generation, we're talking about, from a fiscal point of view, even as bleak a program from the fiscal point of view down the line. Instead of rising water, we're having rising debt to drown our next generations.

Mr. DODARO. Yes, and I think, Congressman, what is going to happen in these long-range projections it is going to occur even sooner. Around the year 2011, the amount of the payroll taxes in excess of Social Security benefits is going to begin to dwindle. So the amount of money that has been available in the past to support current spending for current operations is going to dwindle. In 2017, Social Security goes negative. It is estimated to go negative—in other words, the benefits will be more than——

Mr. BILBRAY. So—when?

Mr. DODARO. 2017. Excuse me. 2017. But the pinch will start to occur in 2011. 2017 that will occur.

Now the Medicare Part A program, the hospital portion, if this fiscal year is in the negative cash position——

Mr. BILBRAY. 2017 our Social Security polar cap melts.

Mr. DODARO. We'll have to start—the government will have to start redeeming the Treasury securities that it has placed as IOUs in order to sustain the program, which means that there will have to be additional borrowings from the public, there will have to be additional spending offsets or revenue enhancements. Something will have to start occurring.

Mr. BILBRAY. I appreciate that.

Daniel, let's talk assets. I guess the biggest problem is Democrats always, in theory, want to talk about revenue enhancers and Republicans all want to talk about fiscal constraints and reduced expenditures. But let's say something we may be able to find common ground on. That is, the assets that the Federal Government owns that may not be managed appropriately.

I was pointing out to the chairman during the vote that one of the greatest losses to the Federal family with the savings and loan was not the savings and loan but the way the assets were liquidated. They were practically given away. Frankly, I think that—I'm astonished that the media did not study how much the assets were lost.

Has anybody even proposed that when we leave our, like, real estate, that we stop giving it away, we stop deeding it over to the local government, we stop deeding it over to the States, we stop transferring from one Department to the other, but look at the fact that this is an asset that may be able to not only generate a sales revenue but then generate more tax revenue and more income for the Federal Government in the long run? Have we talked at all—be willing to talk about——

In Florida—I guess it was in California. It is a good example. Fair market value of that must have been trillions of dollars when you look at it. Has anybody talked about that?

Mr. WERFEL. Actually, Congressman, yes.

First, I'd like to start by pointing out that the law that governs the disposal of Federal real estate is the Real Property Services Reform Act of 1949. So, in the year 2008 we're still operating under a law that was developed in 1949, and the results of that are that we have a very slow and bureaucratic process.

You mentioned some of the concerns that we have, is that before we can dispose of real estate, we have to have it out there in the Federal Register, being looked at by State and local government, being looked at for different law enforcement interests, interests of the homeless, and that process takes more than a year sometimes to get rid of an asset and the process itself disincentives agencies from going through the disposal.

Also, what we also pointed out is that once agencies do make it through that long process and they sell the asset, the proceeds go to Treasury, and the agencies don't get to use those proceeds in a way to improve their mission-critical assets. And what we have done at OMB is try to approach this from a right-sizing perspective where we know that there is not a lot of funds and resources available in the budget each year to invest in our infrastructure, to improve the condition of our mission-critical assets and, at the same time, we also know that we have assets that we don't need.

So what we think what is appropriate is to sell those assets that we don't need or get rid of them and to use those proceeds to invest in our infrastructure and improve the mission-critical assets that we have. And it is for that reason that we have a proposal, a proposed pilot program that would allow agencies to retain 20 percent of the proceeds of sale, but, as importantly, it would allow agencies to take properties direct to market.

Because if we know that we have an asset—and this often is the case—let's say we have a 100,000 square foot warehouse and it is waterfront and we really don't know that there is any—it is not the highest and best use of that asset to be a warehouse, and we think the best interest of the taxpayer from the Federal perspective is to sell that asset to a developer and use that money to help defray the deficit or other funding needs.

I will also point out that the House has introduced a bill that would—very recently that has made it through and I think is out of markup—that would allow agencies to retain 100 percent of their proceeds but doesn't provide for any expedited disposal. So you still have to go through the 1-year process.

Mr. BILBRAY. Well, I think it is something that this committee ought to be looking at.

Mr. Chairman, we actually in San Diego County right downtown had a military headquarters, and they realized that the footprint was worth so much that they went out and worked with the local government to, basically, redevelop it with—an overwhelming majority of it was a revenue-generating visitor seating facility with the headquarters still in there. But rather than just sitting on the footprint, they're now utilizing that.

And I think that kind of approach is one of the things we need to talk about. I think we need to talk about the fact that the revenue sources across the board are not going to hold up.

I think income tax is a hundred years old. My family has been in income tax. My wife owns a business. I just think that there is going to come a time when this crisis is going to force us to look at the fact that there is not a broad enough basis income tax to support the structure anymore. We have to be brave enough to say the emperor has no clothes. The income tax system is 100 years old. We need to look at change in the structure, but I would appreciate allowing the time over, Mr. Chairman.

Mr. TOWNS. Thank you very much, and thank you for your comments as well.

Mr. Patterson, welcome.

Congress responded to GAO's findings of fraud, waste and abuse at DOD by enacting legislation directed at improving the management of DOD's Purchase Card Program. In its most recent work, GAO notes that DOD has improved its internal controls over its purchase card activities. However, GAO still found instances of a lack of accountability over fiscal assets and improper purchase cards used at the Department of Defense. What is being done about that?

Mr. PATTERSON. Actually, we are kind of proud of the fact that DOD was not singled out as one of the agencies who had egregious purchase card violations. But, having said that, our Defense Finance and Accounting Service is very, very fastidious about how they manage and how they determine whether fraud, waste and abuse has taken place. As soon as we find it, we turn that over to the Department's IG and their investigative service, and we are very, very serious about the oversight that we provide for that particular card. And we took it as a wake-up call, as we do always when the GAO finds areas where improvement needs to be done, and our director of Defense Finance and Accounting Service has taken that on as a personal challenge.

Mr. TOWNS. Thank you. Thank you.

Because though we talked about that before and we are happy to see there has been some movement, but still, based on what we understand, there is still a long way to go.

Mr. PATTERSON. I would say there is improvement to be made at the Department, yes, sir.

Mr. TOWNS. Mr. Werfel, certain Federal agencies are unable to adequately account for and reconcile intergovernmental activity and balances. GAO has stated that this failure is one of the three major impediments that continue to prevent GAO from rendering an opinion on the U.S. Government's consolidated financial statements. What is OMB doing to address the longstanding problems of Federal agencies not adequately accounting for and reconciling intergovernmental activities and balance between them? And when can we reasonably expect to see some significant progress?

Mr. WERFEL. This is—thank you for this question. This is one of the issues that OMB—one of the first steps we took was to understand that this is a governmentwide issue. It is not specific to a given agency. So what we did was took it to the CFO Council. The CFO Council was created by the CFO Act to solve governmentwide financial management problems, and we asked the CFO Council to make this one of their No. 1 priorities.

The CFO Council has convened a team, a committee just dedicated to this issue, and they developed a corrective action plan that has four components to it that are producing results today.

The first thing we did was we made standard business rules and published them so that every agency that approaches a transaction with another agency is operating on the same set of rules and regulations, because when there are different rules and regulations for how you transact with one another, that is where some of the problems occur.

The second thing we did was we created a watch list, a high-risk list, if you will, where we identified trading partners with imbalances and said, agency Y and agency X you're off by $1 billion or $100 million. Please come together, meet with OMB and figure out a path toward reconciling this imbalance.

We are in the process of creating a dispute resolution committee, a jury of their peers, so to speak, so that agencies that have disagreements about whether they recorded the right payable or the other agency recorded the right receivable, those can be resolved quickly.

And also and perhaps the largest potential impact is to improve the information technology solution by which agencies transact with one another. Right now, the system that we have is outdated and doesn't have the necessary business rules built into it to make sure that agencies aren't transacting with each other in a way that inaccuracies are occurring.

The one result I'd like to point out—and it is also in my testimony—is when we started this watch list at the beginning of fiscal year 2007, we identified $24 billion in intergovernmental imbalances between agencies, and since that time we have eliminated more than half of it, so over $12 billion. We still have a long way to go. I know these are big numbers, but that is an important first step in this endeavor.

Mr. TOWNS. Right.

Before I yield back to my ranking member, GAO has called for DOD to have a chief management officer to oversee the day-to-day business, transformation efforts within the Department. The National Defense Authorization Act of Fiscal Year 2008 designated the Deputy Secretary of Defense as the CMO. The act also established the position of Deputy CMO and designated that a CMO be established within the military department. Mr. Dodaro, is this still GAO's position?

Mr. DODARO. Mr. Chairman, we still think there needs to be a full-time Chief Management Officer at certain organizations. DOD is one of them. The Department of Homeland Security is another one, and we think that it's a full-time job given the magnitude of the business systems and business processes challenges over at DOD.

We're coming up, we as a Nation, as a government, to another Presidential transition period of time. This will be on its second major Presidential transition since many of these management reforms were put into place, so it's very important for these initiatives to be sustained and the next administration to build on progress that has occurred. We've been pleased at how the current administration has built on the previous administration.

And one of the things that will be going to GAO, since it is cited as a source under the Presidential Transition Act that agencies are encouraged to go to to learn about their new responsibilities—one of the roles that we plan to play is try to encourage progress that needs to be continued. But these problems at DOD and DHS are such that they're not going to be solved within a period of the normal span of any one individual, and they need full-time attention. So it's still our position that you need a full-time Chief Management Officer, and that management officer ought to have a tenure that spans across administrations to make the progress that's needed.

Mr. TOWNS. Right. Take the politics out of it.

Mr. Patterson, what do you think about that? You knew I was going to ask you, didn't you?

Mr. PATTERSON. I was anticipating it actually. As you know, Deputy Secretary England has taken this on as a personal responsibility in that he has taken it on as is directed in the legislation as the chief management officer for the Department. We have an interim process whereby we'll have a process improvement officer that goes through all of our processes that are looking at each one individually, combining them as necessary so that we will have a combined integrated report to the Congress.

The Deputy Secretary, as you know, sits as the co-chair for the Defense Business Systems Management Committee in which we look at all of the systems that are proposed. We evaluate them, and I sit on that committee as well, to determine which ones have merit, which will further the goals of the Department to have a network or information systems that do, in fact, achieve a good financial basis. With the next administration, because the deputy chief management officer is to be a PAS, we'll leave that to the next administration to fill that position.

Mr. TOWNS. Thank you very much, and I yield to the ranking member, Congressman Bilbray from California.

Mr. BILBRAY. David, I'll say this, because the chairman and I are friends, and I think I can be frank about it. Are you guys really comprehending that in 6 months you could be totally under siege as a Department?

Mr. PATTERSON. Could you repeat that?

Mr. BILBRAY. Are you guys comprehending that in 6 months you could be totally under siege from a new administration? Are you ready to answer and take on those challenges, first of all, from one way is the internal operation, but also the massive amounts of reduction of assets? Are you guys even thinking about that at this time in the game?

Mr. PATTERSON. Absolutely. In fact, when I address my colleagues, and when I address the—or have the opportunity to talk to groups of colleagues, I remind them that if you think that what you experience now in terms of cash-flow is going to continue through the next administration, you best be thinking again, and you better be starting to think seriously about how you're going to pare back your expectations in terms of doing your work.

And so, yes, the answer is we fully understand that the level of support that Congress has provided in the past is not something that we should depend upon in the future.

Mr. BILBRAY. I think you're going to be under huge challenges no matter who gets the White House, no matter who controls Congress. I mean, the best-case scenario is not good for the Defense Department. And the question I've got when you get into this, and I'll say this to everybody—let's flip around and try to go in the positive here, what are you doing about improper payment recovery at this time?

Mr. PATTERSON. Our improper payment statistics show that the Improper Payment Act requires that we have no more than $10 million or 2.5 percent, and our percentage has consistently been 0.2 percent. We think that's a good start, but because of the magnitude of our budget, we don't think that's the way in which we should take on this challenge in perpetuity. And we continually attempt and have it as a management action to improve that.

Mr. BILBRAY. Anybody have any comments specifically about the improper payment recovery strategies?

Daniel.

Mr. WERFEL. Yes, I would like to.

Improper payments—implementing effectively the Improper Payments Information Act of 2002 is probably one of the most largest priorities in financial management from OMB's perspective. And looking at where we started in 2004, we really didn't have any public reporting, any sense of the extent of the problem. And where we are today, we are much better equipped to honestly look at the problem, understand it and start to derive effective solutions, and we've already started.

When we first reported in fiscal year 2004, we had $45 billion in improper payments. For those programs that were reported at this time, we've shaved $7.9 billion in improper payments off those dollars. The trend has been—and then in fiscal year 2005, we reported more programs, and in fiscal year 2006 more, and in fiscal year 2007 more. And the trend has been—is once we get those programs out there and have an error rate associated with them and improper payment amount, the agencies are demonstrating an ability to drive those error rates down in subsequent years.

The key challenge that we have is getting those measurements out. We're at the point now where for all those high-risk dollars that we've identified, we're reporting an error measurement on 85 percent of them, and our plans are to have 100 percent reporting by next year. So we're going to be at a point where we have a full vetting, a full picture of this problem.

And what's encouraging is progress so far. If you look at the trends each year, once reported, these numbers are going down, not up. Now, there are exceptions to that rule, and for those exceptions the budget has a suite of different legislative proposals out there to try to help us tackle these problems and issues for the agencies that are not making the type of progress we would like them to make in terms of driving their improper payment.

Mr. BILBRAY. Let's talk about sweeteners on this incentive. What percentage of recovery back into the Department would you recommend? Are we talking 10 percent? What do you think would be the best way to encourage them to participate more robustly? Is that a subtle enough approach?

Mr. WERFEL. We have not to date considered kind of a retention of improper payments as a mechanism or an incentive. The approach that we've taken to date—although it's an interesting idea that I think is worth further discussion. The approach we have taken to date is more of the transparency breeds accountability, and accountability breeds result. So the fact that these numbers are out there, the fact that for the Medicare program in particular—when we first reported Medicare under the Improper Payments Information Act, it had $20 billion in error, and now that number is down to under $10 billion. So the number being out there has motivated the Department to take all the necessary steps and to mobilize resources to get the problem done.

With respect to payment incentives, that's something that I would like to take back to OMB and consider more before I give you a fuller answer.

Mr. DODARO. Congressman, I think this attention to improper payments is one of the real success stories for the Chief Financial Officer Act initiatives. When we first started this back in the early 1990's, nobody knew what the improper payments were from any of these Federal programs. And as Mr. Werfel has talked about, it's focused attention on it going forward. The number, however, is, I believe, going to continue to go up for a while while more programs come under reporting. It went up from $41 billion last year to $55 billion this year, in part because this is the first time the Medicaid program has reported improper payments, and that was only for a 6-month period of time.

Mr. BILBRAY. We really have a culture shock there.

Mr. DODARO. I agree with you. But I think what will happen is the fiscal pressures are going to put enormous scrutiny and transparency over bringing these improper payment numbers down, and hopefully can get embedded into the appropriation process so that it gets a lot of oversight on the part of the Congress. But this reporting is really a good tool, and it's very, very necessary going forward.

Mr. BILBRAY. Dan, let me say this, because I come from 20 years in local government. Given some kind of appearance of incentive really has made the difference. I mean, we actually have in San Diego, a county of over 3 million, larger than 20 States of the Union, we also has a program that gives cash payments to employees who have come in and saved the county funds. We have actually given departments segments.

The Federal Government right now gives major incentives to law enforcement for drug busts. They get to keep assets. It is just—I know in a perfect world we don't want to do that, but it's human nature. We've built the most prosperous free society in the history of the world based on profit incentives—or at least some kind of benefit for good behavior—and I would like to see some way to be able to tap into that, if nothing else, as a gesture of thank you very much for doing your job not just well, but efficiently. And so I hope that we take a look at that. And go ahead. I'll allow you to respond.

Mr. WERFEL. While you were talking, I realized that something that has worked very well that can be built upon is, at the same time the Improper Payments Information Act was passed, the Recovery Audit Act was passed. And what that is about—it is about recovering improper payments made to vendors, and that statute in particular sets up a framework where agencies can hire contractors who get paid to go and find the errors, and they get paid based on how many errors they find. And that program has been so successful in recovering error across government that Medicare programs started using recovering auditing to collect errors from hospitals and other areas. And again, because that contractor is out there looking for errors that were made to their fellow contractors, but they're incentivized because they get more money the more errors they find, that has proven to be one of the more effective lessons learned. So I think we can look at that and see what kind of impact you could have broader on the government as a whole in programs like food stamps and public housing, some of our big-ticket improper payments.

Mr. BILBRAY. I'm sure the chairman has seen that contracting out and using the private sector—maybe we could give the in-house operation some incentive to be able to get a little more efficient. I appreciate that, and I appreciate it, Mr. Chairman.

Mr. TOWNS. Thank you very much. Thank you.

Mr. BILBRAY. By the way, the percentage I would be interested in. If you thought at any time, would you contact my office if you see some kind of place that you think we should be shooting for? We're looking on legislation right now, and that is an interesting point.

Mr. WERFEL. I will do that. Thank you.

Mr. BILBRAY. Thank you, Mr. Chairman.

Mr. TOWNS. Let me just run over a couple other things, and then we'll call it a day.

Mr. Patterson, DOD has acknowledged recently that its business system environment is comprised of approximately 3,000 separate business systems. The Department spends over $15 billion annually to operate and maintain and modernize these business systems and associated information technology. Fifteen billion dollars is a lot of money. Even for DOD, that's a lot of money. How many modernization efforts has the Defense Business System Management Committee evaluated and decided that there were not a good investment, how many?

Mr. PATTERSON. We have a vetting process that has an intermediate review board that looks at all of the systems that are proposed. I can't tell you how many that we have rejected, but I can tell you that very few come to the Defense Business Systems Management Committee.

And for a more detailed look at the process, with your concurrence, I would like Dave Fisher, who actually is the Director of the agency that deals with this issue, to answer your question more, in a more detailed fashion.

Mr. TOWNS. I would be delighted to.

Would you take a seat at the table, please?

Mr. FISHER. As Mr. Patterson alluded to, what we have found and what was helpful going back to the 2005 NDAA, which stood up or required the Department to stand up the DBSMC as well as investment review boards across the functional areas within the Department, what we found is that, as Mr. Patterson alluded to, this vetting process has done some self-editing, if you will, of the proposals that would come forward. There were some systems that came forward through these investment review boards that were turned down or were pushed back for further analysis to make sure that they were not causing problems with a broader portfolio, either duplicative or overlapping. That kind of visibility started to come forward at the Office of the Secretary level when these investment review boards came into play.

Well, I think most of the systems that eventually find their way to the DBSMC do get approval. Many fewer systems are coming forward because of this same vetting process. It's got to go through the component initially. So the military departments have put in their own process, then it comes through the Office of the Secretary of Defense process for investment management, then it comes to the DBSMC. And what we've seen is, the volume of systems that have come forward to the top where final approval is required has gone down, we think, because this more rigor now has been put in place.

Mr. TOWNS. It is our understanding that some of the Department's business-system modernization efforts, such as the Army Logistics Modernization Program, the Navy Enterprise Resource Planning Initiative and the Defense Integrated Military Human Resources System, have not been implemented in accordance with their plan, schedule and estimated budget. What does DOD—let me put it this way: Why does DOD continually have difficulty implementing these business systems on time within the budget? I mean, what is the problem?

Mr. PATTERSON. Having come from the corporate world, I can give you a point of view, and I would like to use the Logistics Modernization Program as an example. When I first joined the comptroller office, I had a review of the various programs that we were looking at. LMP was the first program that popped up in one of the meetings. I was told that this program needed an additional $320 million. I asked how much had already been spent, and I thought it was somewhat excessive. And I said, well, tell me how is it working, and they said, oh, well, we have a pilot program. I said, really, and how long have you had this pilot program? For about 3 years. And again my question: How is this working? What kind of a contract is this? It's an IDIQ contract, I see. And what's the not-to-exceed? Oh, that's $1.2 billion. And I said, so you got an IDIQ contract, $1.2 billion, you don't have a program, and you want $320 million more? No. You'll get $20 million, you'll tell me next year how you're going to fix this program, and then we'll go from there.

Amazingly enough the contractor figured out how they were going to fix the program, and LMP is back on track and will have a—in fact, is turning out a product as we speak in a way that they had envisioned some time ago. What it takes is putting discipline and structure into the process and not allowing contractors to run the program.

Mr. DODARO. Mr. Chairman, I would want to echo the concerns that Mr. Patterson is mentioning. We look at systems across government. I've spent a lot of time looking at DOD. We've put DOD on our high-risk list in several respects, both in financial management and the business systems area, as well as a weapon systems. I just signed out a report not that long ago that talked about the huge cost overruns and managing in the weapons system area.

But with regard to the business systems, part of the problem is lack of definitive requirements up front as to exactly what you want to achieve, incremental improvements where you demonstrate some success before you make large investments in the process. So you need a disciplined management system going forward, and part of the problem over at DOD as well is that you have just large components with large investments, and it's difficult for the Office of the Secretary to provide the oversight over the components.

It was mentioned earlier, some of the systems aren't coming up for review, but there needs to be an oversight process within the Department to make sure the components have discipline processes in place as well.

So those are some of the fundamental reasons. It all starts with a good definition of requirements and somebody questioning that before the investment is made, particularly long-term investments. It needs to be more incremental.

Mr. TOWNS. Thank you very much.

Do you have any further questions?

Mr. BILBRAY. Just one. The fact is when we work with DOD—I worked on environmental issues in California, and there was a thing called technology-forcing regulation, and basically the military works with technology-forcing contracting. It's just cutting edge. You're literally contracting for things that nobody can do now, but they may be able to do, and you push that edge. That's how we ended up with a P–51. When the contract was going out, nobody in the system even conceived of a fighter that could fly that far and protect our B–17.

So let's talk about the successes. But inherent in that is some real challenges. Let's talk about a program the American people love, it looks very successful, the Predator, and the way the Predator came on line. Is there anything we learned there with the program that looks like it was a huge, huge success, which challenges why originally it wasn't accepted, why there was so much obstruction? And you don't have to do it now, but I really would be interested. That is sort of one, so if we see how—where it works, maybe we can use that to learn of what the things that don't work and make sure that we don't throw the baby out with the bath water, because I think right now the system, if it wasn't for, I hate to say, an earmark, we would never have the Predator. And I think everybody now agrees that thank God we had it.

But I would like to learn from that mistake of the system not initially going forward, but developing it. And I know there is still an ongoing issue with the Predator, but I would like to know the background on that so we can sort of learn from successes and failures on that aspect. It's something high enough profile that the public could relate to it, too.

Mr. PATTERSON. Sir, we'll get you a detailed paper on the history and what we see as the Predator's future, and you're exactly right; it was a very successful program. It did not start out that way, however. It had considerable resistance, and if you'll recall it, the Predator as an ISR platform went from an ISR platform to a platform that shot Hellfires in about 90 days because we had to do it.

Mr. BILBRAY. I'm still suspicious. Mr. Hunter is a very close friend of mine, and he pushed that Predator. I was very suspicious when the next generation came out and it was called the Hunter.

Thank you very much, Mr. Chairman.

Mr. TOWNS. Let me just say quickly, if DOD—Mr. Dodaro, if DOD does achieve a clean audit opinion on its financial statement, does that automatically justify removing DOD financial management from GAO's high-risk list?

Mr. DODARO. Not in and of itself, Mr. Chairman, for a couple of reasons. One, we would want to make sure that could be sustained over a period of time; No. 2, that there's not material weaknesses that would basically still be problematic that would be solved.

I mean, that's a first step toward it, and if DOD got to that step, we would be very pleased to see that happen. But as we've taken on this issue in other departments and agencies, the opinion needs to be sustained over a period of time, and there needs to be not underlying material weaknesses that still make it at risk.

So the answer would be it would be: a good first step, but in and of itself it's not enough.

Mr. TOWNS. Mr. Patterson, what do you say to that, other than you would take yourself off the list?

Mr. PATTERSON. No, sir. Actually, as appealing as that suggestion might be, we are working with the GAO. My question would be, what are the standards necessary to achieve in order to reduce the risk as GAO sees it? We're working with the GAO to come to those kinds of conclusions. But I think it's important to note that although there is a relationship between material weaknesses and clean audits, you can, in fact, have a clean audit and still have some material weaknesses that you are working on. And so we have really a dual-track approach to this, and we're working with the GAO.

In fact, when we had our audit readiness meeting to look at the Marine Corps as the first military department or the first service to start down a path of a clean audit, we had OMB, IG and the GAO in attendance so that we would have a very clear understanding of a way forward. We have adopted an audit readiness approach to this, which has replaced the previous way of looking at this where we had repetitive audits that were very expensive and basically told you what you already knew. And now we look at these entities in terms of, are they ready for an audit, and we have a clear and structured process to do that. And again I say that we're working with the GAO and IG and OMB, and it has been a very productive relationship.

Mr. TOWNS. Let me thank you for coming, and let me just say to you that we're going to stay on this because we really feel there's a lot of waste, fraud and abuse. We really feel that, and I think that some of it might even have to do with the structure that you might have to review at some point in time to make some changes in order to be able to get to where we need to go.

So thank you very, very much, but we're here to help. As my colleague indicated earlier, we want to assist you. We're just not raising these questions just to sort of like create problems, but we want to see in terms of what we might be able to do on this side to assist you. Because we feel that there's a lot of resources there, and for some reason we're having problems getting a handle on it.

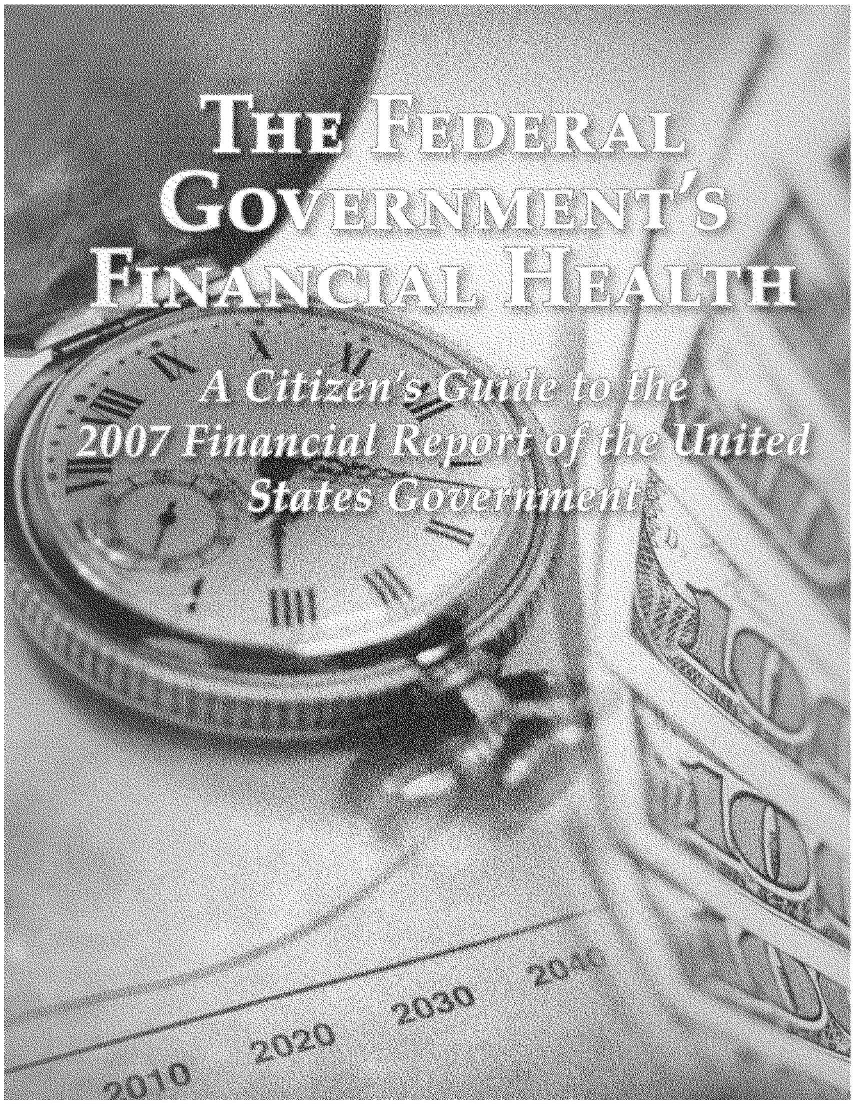
Mr. BILBRAY. And I think that's fair to say that when we say a lot of waste, fraud and abuse, by sheer volume a small percentage still is one big hunk, and so as a little operation may make some big mistakes and it may not add up. You are so large that any small mistake is a huge hit, and so there is a lot and always will be the challenge to try to reduce that down.

Thank you very much, Mr. Chairman.

Mr. TOWNS. All right. Thank you. The committee is adjourned.

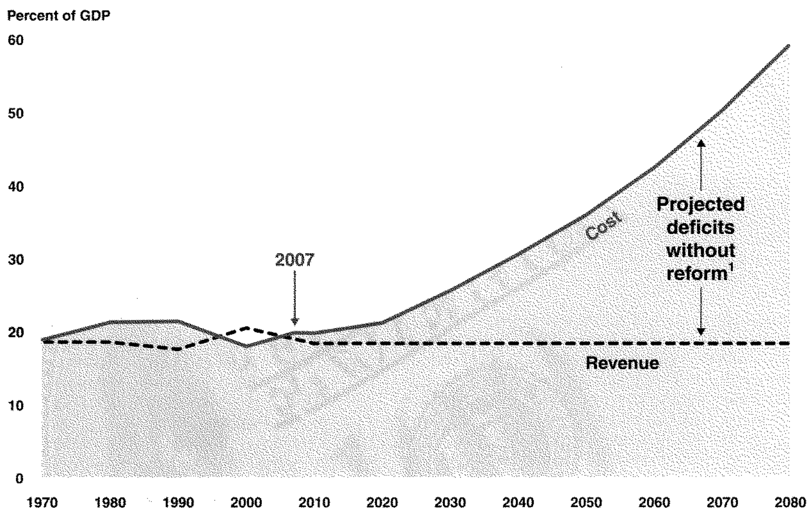
[Whereupon, at 4:37 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]


THE FEDERAL GOVERNMENT'S FINANCIAL HEALTH
A Citizen's Guide to the 2007 Financial Report of the United States Government
2010
2020
2030

The Government Is On An Unsustainable Fiscal Path

Chart 1: The Government Is On An Unsustainable Fiscal Path



Key dates

2007	Medicare Part A benefit payments began to exceed the program's tax revenue.
2017	Social Security benefit payments will begin to exceed the program's tax revenue.
2019	Medicare Part A Trust Fund assets will not be enough to pay full benefits. Under current law, benefits would be reduced to 79 percent of scheduled benefits in 2019, declining to 29 percent by 2081.
2040	Federal debt held by the public will exceed the historical high of 109 percent of GDP.
2041	Social Security Trust Funds' assets will not be enough to pay full benefits. Under current law, benefits for all retirees would be reduced to 75 percent of scheduled benefits in 2041, declining to 70 percent by 2081.
2080	Total government cost will be more than three times revenue.

Notes:

1. Projected deficits represent projected cost in excess of revenue, where revenue as a percent of gross domestic product (GDP) is set equal to its historical average and projected cost is based on scheduled Social Security and Medicare benefits and current cost trends. While the precise amounts of the government's financial responsibilities are far from certain—they are based on many complex calculations and assumptions, including life expectancies and health care cost—their magnitude and the need to control them are evident.

2. The dates and events presented above are taken from the 2007 Annual Reports of the Social Security and Medicare Boards of Trustees and the *2007 Financial Report of the United States Government*.

Overview

This Citizens' Guide (guide) highlights important information in the *2007 Financial Report of the United States Government.*[1] The Secretary of the Treasury, Director of the Office of Management and Budget (OMB), and Comptroller General of the United States believe that the information discussed in this guide is important to all Americans.

While attention has been recently focused on addressing emerging challenges in today's economy, the last 3 years show economic growth and improvement. Revenue went up, deficits went down, and cost stayed fairly constant. But as you can see in chart 1, the government faces a huge fiscal challenge in the years ahead. This year, 2008, is the year in which the first of the approximately 80 million baby boomers—those born between 1946 and 1964—become eligible to draw Social Security benefits. Scheduled Social Security and Medicare benefits together with other federal programs' projected long-term cost are much greater than the resources (revenue and borrowings) available to pay for them.[2] Unless action is taken to bring program cost in line with available resources, the coming surge of entitlement spending will end in a fiscal train wreck that will have an adverse effect on the U.S. economy and on virtually every American.

Where We Are Now

- Strong growth in individual incomes and corporate profits contributed to 4 consecutive years of tax revenue growth—revenue was up by 46 percent since 2003 to $2.6 trillion in 2007.[3] Social Security and Medicare tax withholdings accounted for almost a third of total revenue in 2007.
- Social Security Trust Funds' revenue exceeded what the government paid out in benefits by $186 billion in 2007. This surplus was credited to the Trust Funds.
- The government's total operating cost remained relatively constant—$2.9 trillion in 2006 and in 2007.
- Revenue increases and relative cost stability resulted in a drop in the government's net operating cost—to $276 billion—and a decline in the unified budget deficit (budget deficit)—to $163 billion in 2007.
- To fund cumulative budget deficits, the government has borrowed a total of $5 trillion from the public as of the end of fiscal year 2007. The government has also borrowed excess annual cash flows from the Social Security and Medicare Trust Funds and similar funds to finance other government cost. Including interest, the government owes $4 trillion to these funds, which is backed by the full faith and credit of the government, resulting in total federal debt of $9 trillion.

Where We Are Headed

- As baby boomers retire and health care cost continue to rapidly rise, the cost of the Social Security, Medicare, and Medicaid programs will account for a growing portion of government cost.

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[1]The administration annually issues two complementary reports on the government's finances. *The Financial Report of the United States Government (Financial Report)*, issued by the Department of the Treasury, analyzes how revenue was spent in the fiscal year on programs and services and discusses the government's resulting financial position. Cost is reported at the time an obligation to pay arises rather than when payments are made. The *President's Budget* is the government's primary tool for financial planning and control. It focuses on taxpayers' dollars the government collects, how it uses them to support programs and services, and whether this use results in a surplus or deficit.

[2]This calculation assumes future government revenue as a percent of GDP is at its average historical rate of about 18 percent, and uses current spending trends to project the cost of federal programs other than Social Security and Medicare.

[3]The government's fiscal year begins October 1 and ends September 30.

- Absent reforms, the Social Security Trust Funds will be exhausted in 2041 and the Medicare Part A Trust Fund will be exhausted in 2019. Revenue dedicated to these entitlement programs under current law will not be enough to pay for scheduled Social Security and Medicare Part A benefits.
- The projected cost of all federal programs will exceed available resources. Unless the government brings program cost in line with available resources, resulting budget deficits will be so large that the government will not be able to borrow enough to fund them.
- Our children and grandchildren will bear a greater burden of the cost if we delay in implementing fundamental reforms.

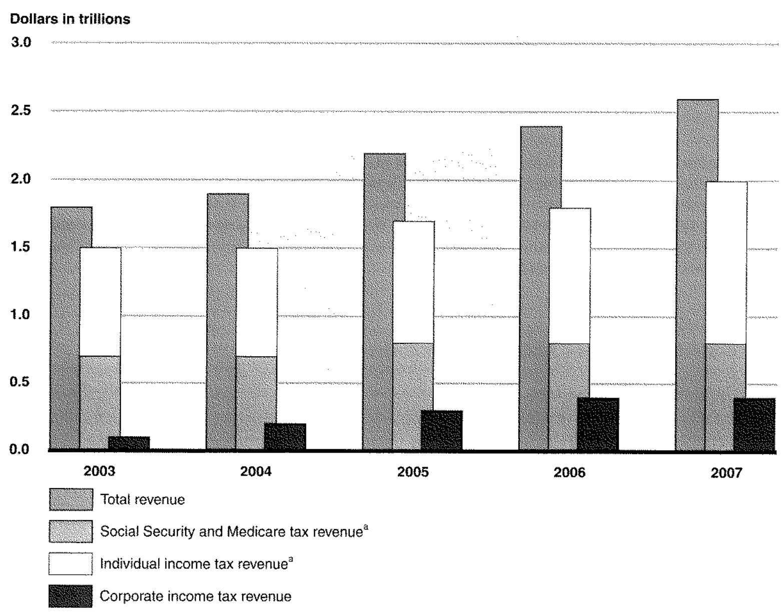
Where We Are Now

What Came In and What Went Out

What came in? In 2007, government revenue totaled $2.6 trillion. What went out? The government's operating cost totaled $2.9 trillion. The "bottom line" net operating cost—the difference between revenue and cost—was $276 billion—a $174 billion decrease from 2006. It is also more than $100 billion greater than the unified budget deficit, as it includes approximately $90 billion in accrued, but as of yet unpaid, post-employment benefits to the millions of people who are part of the government's current and retired civilian and military workforce. The budget deficit is the amount by which the government's spending exceeds its revenue, and thus, is a measure of how much the government has to borrow from the public. The budget deficit decreased $85 billion to $163 billion in 2007.

In 2007, a growing U.S. economy led to record revenue of $2.6 trillion. Chart 2 shows that government revenue increased steadily from 2003 through 2007, largely because of taxes on increasing individual incomes and corporate profits. Social Security tax revenue of $648 billion and Medicare tax revenue of $200 billion accounted for almost a third of total revenue. The recent slowing of U.S. economic growth will have an effect on 2008 revenue.

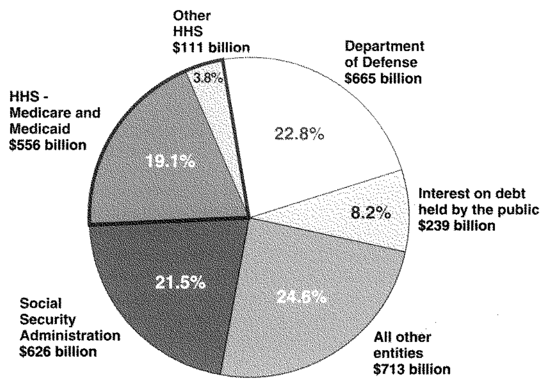
Chart 2: Government Revenue 2003-2007



[a]In the *Financial Report*, Social Security and Medicare tax revenue are combined with individual income tax revenue.

The government's net cost in 2007 was relatively constant compared to 2006. Chart 3 shows that in 2007, the Department of Health and Human Services (HHS), Department of Defense, and Social Security Administration, plus interest on debt held by the public, accounted for approximately three-fourths of the government's total net cost. Medicare cost of $368 billion and Medicaid cost of $188 billion accounted for more than 80 percent of HHS' total net cost in 2007.[4]

Chart 3: Government Net Cost 2007



The Debt

The government incurs debt when it borrows from the public to fund its budget deficits. The government also incurs debt when government funds invest their excess receipts in government securities. Of the government's total debt of about $9 trillion at the end of 2007, approximately $5 trillion was debt held by the public in the form of Treasury securities, such as bills, notes, and bonds. The public includes individuals, corporations, state and local governments, Federal Reserve Banks, and foreign governments.

The balance of the debt—nearly $4 trillion—was intragovernmental debt. This represents debt held by government funds, including the Social Security ($2.2 trillion) and Medicare ($359 billion) Trust Funds. These government funds are typically required to invest any excess annual receipts in federal securities. When the government borrows these excess receipts, it still has an obligation to repay them to the government funds with interest. If expected budget deficits continue, as the government funds redeem the federal securities to pay for benefits or other program cost, then additional borrowing from the public will likely be required.

[4]Medicare cost is net of related premium revenue.

Where We Are Headed

An Unsustainable Fiscal Path

The projected growth in spending for Social Security and Medicare benefits affects every citizen in the nation.[5] Scheduled benefits under these programs are expected to exceed dedicated revenue (e.g., payroll taxes and premiums) by more than $40 trillion (present value) over the next 75 years, under current laws and policy.[6] The fiscal imbalance is even larger looking beyond 75 years.[7] Moreover, without reform

- In **2007**, Medicare Part A benefit payments began to exceed the program's tax revenue.
- In **2011**, the Medicare Part A Trust Fund begins to decline as benefits exceed payroll taxes and trust fund interest.
- In **2017**, Social Security benefit payments will begin to exceed the program's tax revenue.
- In **2019**, Medicare Part A Trust Fund assets will not be enough to pay full benefits. Under current law, benefits would be reduced to 79 percent of scheduled benefits in 2019, declining to 29 percent by 2081.
- In **2027**, Social Security Trust Funds begin to decline as benefits exceed tax revenue and trust fund interest.
- In **2040**, federal debt held by the public will exceed the historical high of 109 percent of GDP.
- In **2041**, Social Security Trust Funds' assets will not be enough to pay full benefits. Under current law, benefits for all retirees would be reduced to 75 percent of scheduled benefits in 2041, declining to 70 percent by 2081.
- In **2080**, total government cost will be more than three times revenue.

[5] The dates and events described in this section are taken from the 2007 Annual Reports of the Social Security and Medicare Boards of Trustees and the *2007 Financial Report*.

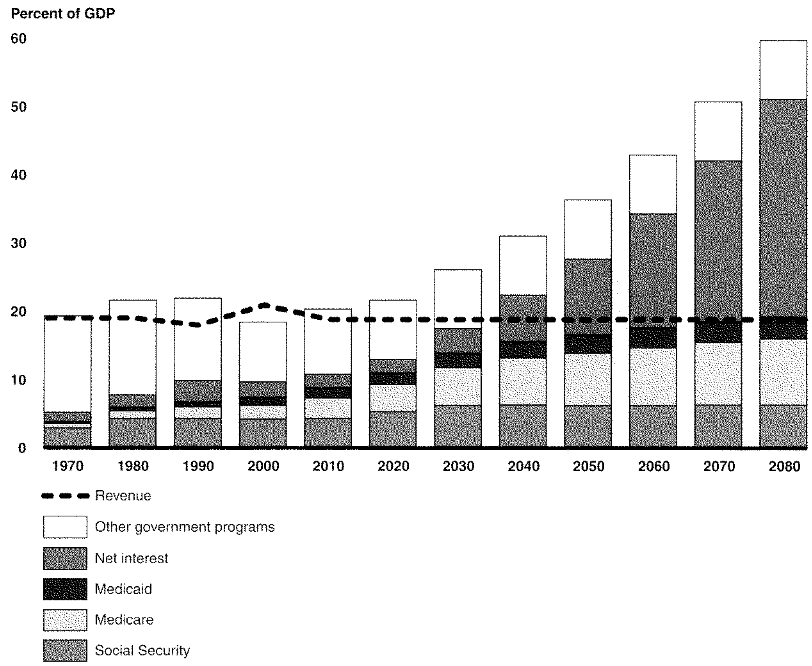
[6] This estimate, included in the fiscal year 2007 Statement of Social Insurance, may be found in the *2007 Financial Report*.

[7] The 75-year horizon includes the revenue from people working in the latter part of the 75-year period but not the associated benefits that will be paid when these same people retire after the end of the 75 years.

Fundamental Reforms Are Needed Now

Chart 4 shows government revenue and spending as a percent of GDP from 1970 through 2080.[8] Since World War II, federal revenue as a share of GDP has been roughly constant at around 18 percent.[9] Whenever taxes rose, policy actions tended to pull them back.

Chart 4: Government Revenue and Cost 1970-2080



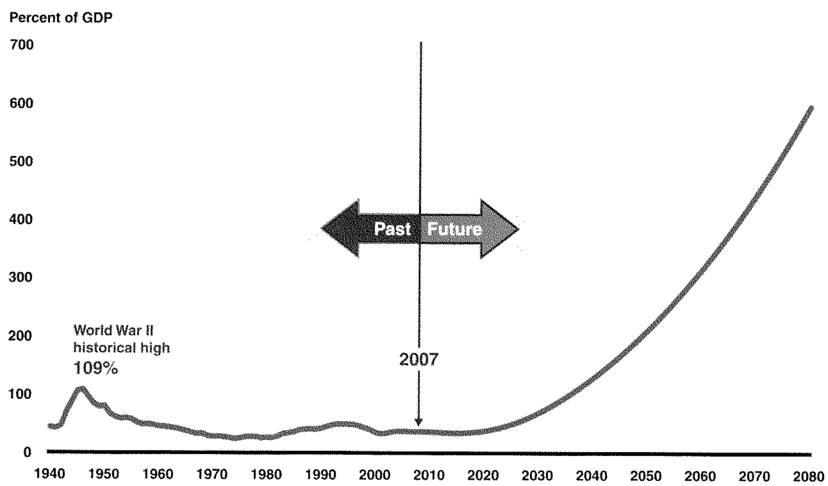
If revenue is held constant at about 18 percent of GDP (the historical average level), government spending will eventually exceed the government's ability to pay. By 2070, total government cost is projected to be 50 percent of GDP mainly because of mounting interest cost. Cost-to-GDP ratios have not been this high since World War II, when cost briefly reached 44 percent of GDP. By 2080, cost reaches nearly 60 percent of GDP, more than three times the average historical level of revenue as a percent of GDP. The dates and numbers would change with different forecasting assumptions, but under a wide range of reasonable projections, the increases in budget deficits will be dramatic.

[8]Projected spending is based on scheduled Social Security and Medicare benefits and current spending trends. Revenue as a percent of GDP from 2010 to 2080 is assumed to equal its historical average.

[9]GDP is one way of measuring the size of a nation's economy and is defined as the total market value of all final goods and services the nation produces in a given period. The projection that the government's revenue as a percent of GDP will remain relatively constant is based on historical data and trends that are not expected to change.

Chart 5 shows the extreme effect on the debt of projected budget deficits indicated in chart 4. These combined trends will cause government debt levels to more than triple by 2040 and to more than double again by 2060. The nation's debt could approach 600 percent of GDP by 2080. This far exceeds the historical high of 109 percent of GDP that occurred during World War II.

Chart 5: Federal Debt Held by the Public 1940-2080



The nation must change course before the deficit and debt reach unprecedented heights. The government must bring program cost in line with available resources. Delays in taking this action will increase the magnitude of the reforms needed and will place more of the burden on our children and grandchildren.

While the precise amounts of the government's financial responsibilities are far from certain—they are based on many complex calculations and assumptions, including life expectancies and health care cost—their magnitude and the need to control them are evident.

Looking Ahead

In the *2007 Financial Report*, the Secretary of the Treasury indicates that the nation must look to the future, particularly the spending demands of Social Security and Medicare, and squarely face the need for fundamental reform if these programs are to be sustained. The government must strive to make all disclosures transparent, provide all points of view with relevant data, and expand financial and fiscal reporting in order to explain why estimates of future Social Security and Medicare costs increase year after year.

The issues discussed in this guide affect, and should be of interest to, every citizen. The *Financial Report's* comprehensive reporting is intended to inform and support the decision-making needs of lawmakers and the public and to help keep the United States on solid financial ground.

Finding Out More

You will find more detail on these matters in the *Financial Report*. You are encouraged to explore the information it contains and to ask questions about how the government manages taxpayers' money. The *2007 Financial Report of the United States Government* and other information about the nation's finances are available at:

- U.S. Department of the Treasury's Financial Management Service, http://www.fms.treas.gov/fr/index.html;
- OMB's Office of Federal Financial Management, http://www.whitehouse.gov/omb/financial/index.html; and
- GAO, http://www.gao.gov/financial/fy2007financialreport.html.

This guide can be obtained on-line at the above Web sites.

This Citizens' Guide highlights information in the *2007 Financial Report*. The Government Accountability Office's (GAO) complete audit report on the U.S. government's consolidated financial statements can be found beginning on page 159 of the *Financial Report*. For 2007, for the first time, GAO issued an unqualified or "clean" opinion on the Statement of Social Insurance. However, certain material financial reporting control weaknesses and other limitations on the scope of its work prevented GAO from expressing an opinion on the remaining financial statements.

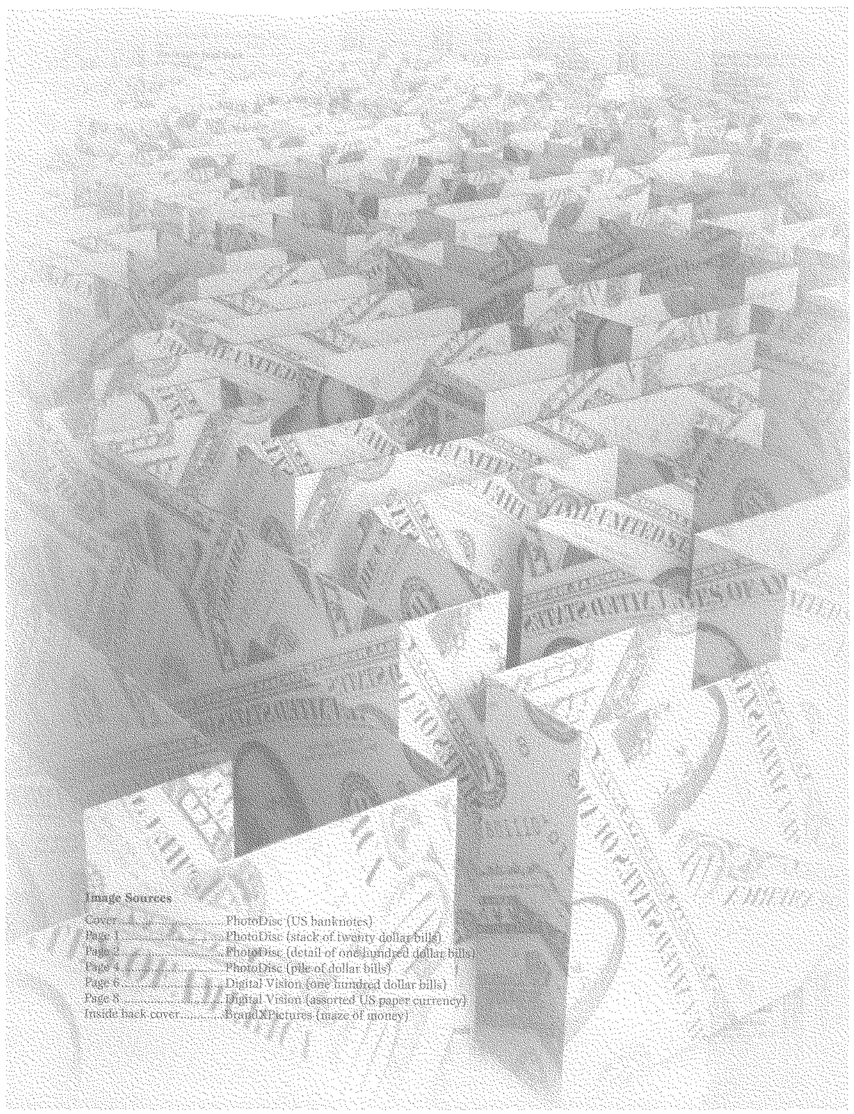


Image Sources
Cover.........PhotoDisc (US banknotes)
Page 1.........PhotoDisc (stack of twenty dollar bills)
Page 2.........PhotoDisc (detail of one hundred dollar bills)
Page 4.........PhotoDisc (pile of dollar bills)
Page 6.........Digital Vision (one hundred dollar bills)
Page 8.........Digital Vision (assorted US paper currency)
Inside back cover.........BrandXPictures (maze of money)

GAO
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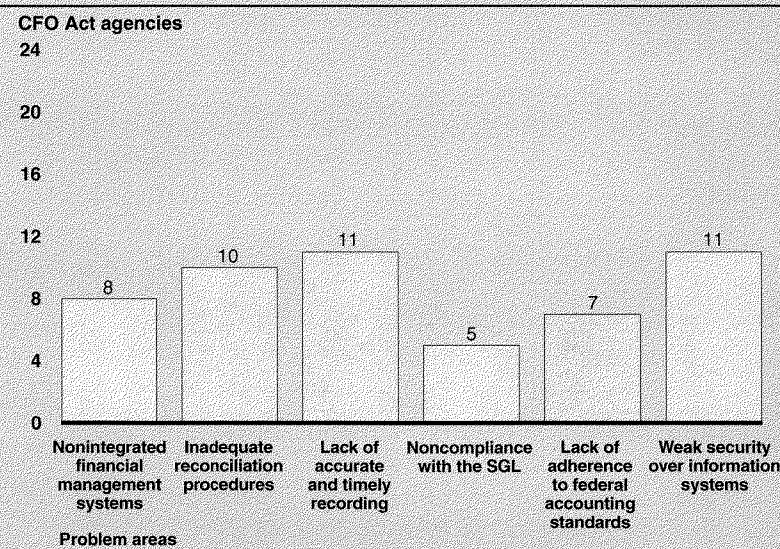
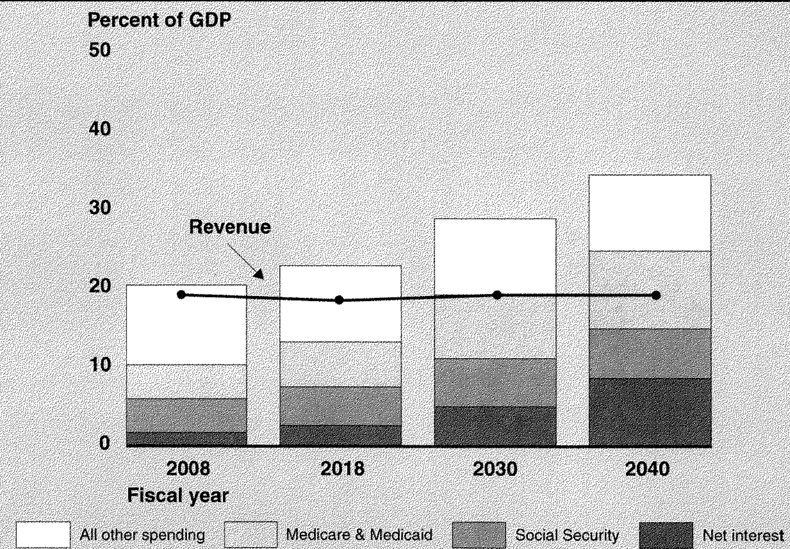
Number of 24 CFO Act Agencies with Reported FFMIA Compliance Problems for Fiscal Year 2007



Source: GAO analysis based on independent auditors' financial statement audit reports prepared by agency inspectors general and contract auditors for fiscal year 2007.

Potential Fiscal Outcomes Under GAO's Alternative Simulation: Revenues and Composition of Spending as Shares of GDP



Source: GAO's April 2008 analysis.

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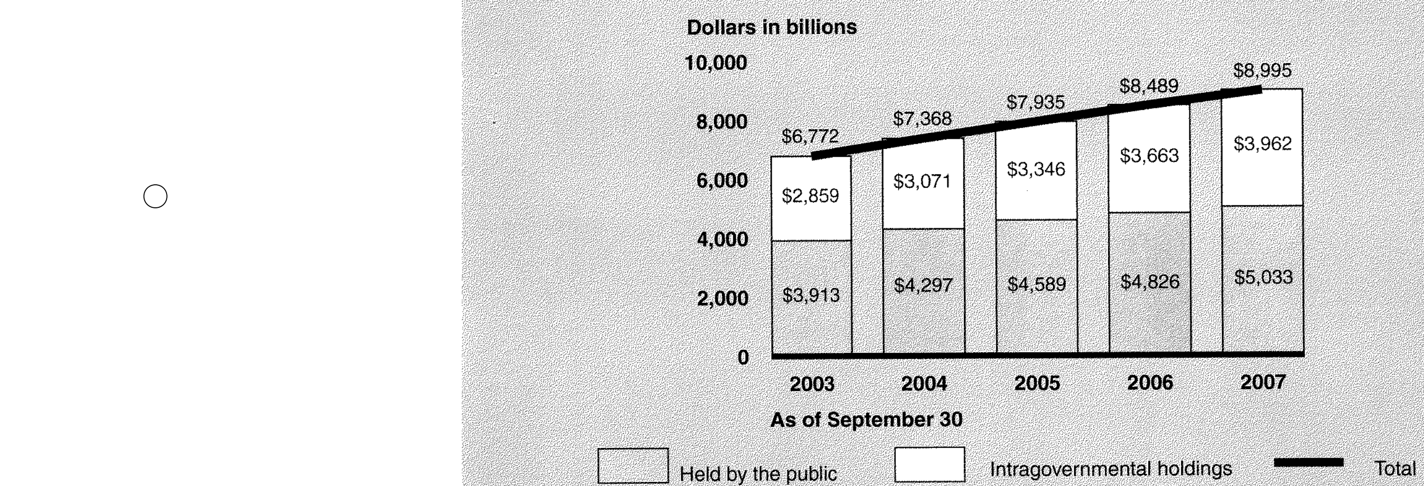
Total Federal Debt Outstanding



Source: The Department of the Treasury.