OVERSIGHT OF FEDERAL FINANCIAL MANAGEMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, ORGANIZATION, AND PROCUREMENT

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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OVERSIGHT OF FEDERAL FINANCIAL MANAGEMENT

WEDNESDAY, APRIL 14, 2010

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 10:05 a.m., in room 2247, Rayburn House Office Building, Hon. Diane E. Watson (chairwoman of the subcommittee) presiding.

Present: Representatives Watson, Cooper, Connolly, Cuellar, Quigley, Schock, Luetkemeyer, and Issa (ex officio).

Staff present: Bert Hammond, staff director; Valerie Van Buren, clerk; Adam Bordes and Deborah Mack, professional staff members; Adam Fromm, minority chief clerk and Member liaison; Hudson Hollister, minority counsel; and Mark Marin, minority professional staff member.

Ms. WATSON. The Subcommittee on Government Management, Organization, and Procurement of the Committee on Oversight and Government Reform will now come to order.

Without objection, the Chair and the ranking member will have 5 minutes for opening statements, followed by opening statements not to exceed 3 minutes by any other Members.

Without objection, Members and witnesses may have five legislative days to submit a written statement or extraneous materials for the record.

I will now begin the hearing with my statement.

I would like to welcome everyone to this morning's hearing on the Federal Government's consolidated financial records and statements for fiscal year 2009 and the subcommittee's review of Federal agencies' progress to date in modernizing their management systems and internal controls.

I welcome our distinguished witnesses and look forward to hearing all of your testimony.

The Government Management Reform Act of 1994 instructs the Secretary of Treasury, in coordination with the Director of the Office of Management and Budget, to submit financial statements on an annual basis to the President and to the Congress. GAO is required to audit these statements, and today's hearing will review the findings of the Department of Treasury and OMB, as well as GAO's audit.

For the 13th consecutive year, GAO was unable to render an unqualified audit opinion for fiscal year 2009 due to ongoing material weaknesses that were caused by problems related to internal controls over financial reporting. The statement of social insurance, however, was issued a clean audit opinion and the total number of reoccurring material weaknesses held constant at 29, but the overall number of weaknesses documented increased from 32 to 38, mostly due to irregularities in financial management and reporting.

The subcommittee would like to hear how the material weaknesses in financial reporting and other internal controls by Federal agencies continue to affect the Federal Government's fiscal conditions. The subcommittee is particularly interested in hearing more from Mr. Millette of the State Department and Mr. Easton from the Department of Defense about their agencies' challenges in these areas and their efforts to resolve these issues.

The subcommittee is aware of the extraordinary and unprecedented efforts the Federal Government has undertaken to shore up the Nation's fiscal markets in 2009, as well as the fiscal challenges our Government faces in meeting its obligations for major social insurance programs that will appear down the road. Obviously, there comes a time when the rubber must meet the road, and many of us would agree, to use a mixed metaphor, that there is a shrinking window of opportunity for implementing necessary policy changes to meet these critical budgetary challenges.

With that in mind, I look forward to the observations of our panel of Government witnesses on the current conditions of the Nation's financial health, as well as any other observations you may have on what efforts must be made to ensure the ongoing fiscal health of our Nation.

And for our second panel, we will hear from several expert witnesses regarding Representative Henry Cuellar's legislation, H.R. 2142, or the Government Efficiency, Effectiveness, and Performance Improvement Act of 2009. The intent of Mr. Cuellar's legislation is to buildupon the Government Performance and Results Act of 1993 by requiring that every Federal program be excessed at least once every 5 years. The legislation also establishes the performance improvement council and agency improvement offices.

Once again I would like to thank our panelists for joining us today. I look forward to their testimony.

Now I will call on our prestigious minority representative.

Mr. SCHOCK. Thank you, Madam Chair. I appreciate your convening today's meeting on this very important matter.

Auditing the Federal Government's financial statements is a massive responsibility but a vitally important one. Understanding how and how well the Federal Government manages and spends our taxpayer dollars will lead to greater transparency for the American people, an opportunity to see where financial management improvements can be made, and can potentially save billions of dollars each year.

In 1996, only six agencies received a clean audit. Now we are up to 20 out of the 24 CFO Act agencies receiving an unqualified opinion on their financial statements. There is no doubt that some improvements have been made; however, persistent problems remain.

For the 13th straight year, GAO was unable to render an opinion on the Government's consolidated financial statements due to persistent financial management problems at the Department of Defense, the Government's inability to account for interagency funding activity, and other ineffective systems, processes, and internal controls at our Federal agencies. In fact, the very agencies that are responsible for public company reporting and tax compliance do not have effective control over their own financial reporting.

At the Securities and Exchange Commission GAO found that automatic accounting systems could not generate useful financial reports, requiring extensive manual work-arounds. At the IRS, GAO found that financial management systems failed to comply with the law. One could fairly ask: how can these agencies require effective financial reporting from companies and individuals in the private sector and not practice it themselves?

The private sector, which has frequently faced the challenge of reconciling transactions between disparate subsidiaries of a consolidated corporate parent, has developed technology solutions to similar accounting problems. The Federal Government lags far behind the private sector in implementing and making use of these technological solutions.

GAO was able to offer an unqualified opinion on the statement of social insurance, which includes Medicaid and Social Secretary. However, as a recent news story on this topic stated, "While the bookkeeping of the statement of social insurance might be reliable, it is hardly good news." The financial statements show that the projected scheduled benefits exceed the earmarked revenues for Social Security and Medicaid by $46 trillion during the next 75 years.

According to GAO, increased spending and borrowing and decreased revenue associated with TARP and stimulus spending added massively to the Nation's debt, and GAO states in its report that Federal debt held by the public as a share of GDP could exceed the historical high reach in the aftermath of World War II by 2020, 10 years sooner than projected just 2 years ago. GAO concludes that the Federal Government is on an unsustainable long-term fiscal path.

I am also concerned about the ongoing and growing problem of improper payments. An improper payment is Government jargon for a dispersal of taxpayer money which should never have been made, a payment that went to the wrong company or organization or that was made for an incorrect amount. In fiscal year 2009, OMB reported that the Federal Government made $98 billion in improper payments, and OMB admits that this figure doesn't even cover all of the at-risk outlays, and therefore doesn't reflect the full total of incorrect payments the Federal Government made in the fiscal year 2009.

With that, Madam Chair, I thank you once again for holding this hearing today and look forward to the testimony of our panelists and the productive conversation on how we can continue to improve the financial management of our Federal Government.

With that, I yield back.

Ms. WATSON. I now yield to the distinguished Member, Mr. Quigley.

Mr. QUIGLEY. Thank you, Madam Chairman.

I think this is my anniversary. I have been here a year now. I was expecting a cake.

[Laughter.]

Mr. QUIGLEY. What is striking to me in that anniversary date is where I came from. I was a Cook County Commissioner in Chicago, and when I got there 11 years ago the big scandal was that our Forest Preserve District had not done appropriate audits for 5 years, and we found out we were $19 million in debt, and we had people on the payroll who weren't attached to the budget. That was seen as an extraordinary problem. I guess fast forward to today. It is extraordinarily frightening that the decimal point moves way over to the right, but the fact that we don't know, we don't have a handle on our finances is all the more frightening, because without proper audits of the Federal Government's finances we are essentially flying blind, and it is a big plane.

How can we begin to create efficiencies or cut waste if we don't have a proper accounting of where and how our funds are being spent? We have to have an accurate lay of the land before we begin reforming. The path out needs to know where we are in the first place. Proper oversight of the Federal spending is especially important now. The Federal Government is taking on unprecedented amounts of debt and liability through the stimulus, TARP, including extraordinary investments in Fannie and Freddie. Our National debt as a percentage of GDP is on track to reach levels not seen since World War II due to entitlement growth and unchecked spending.

We need some serious reforms to reign in Federal spending and put our budget in a sustainable path. All I would say is that the first part of this must be an accounting. It must be an appropriate accounting so we know where we are and we know what changes that we put in place will do to affect our balance sheet.

Thank you, Madam Chairman.

Ms. WATSON. Thank you.

I now yield to the distinguished Mr. Darrell Issa.

Mr. ISSA. Thank you, Madam Chair, and thank you for holding what I hope will be the first of many hearings that begin to grapple with the larger problem.

In reference to the larger problem, one of the people that is not given enough credit in history for creating the modern Government was Dwight David Eisenhower. He began the process of saying that we were going to have to increase the efficiency in using modern technology. Sadly, he went to his grave, and many Presidents since him have gone to his grave without the Federal Government knowing how to use computers to actually do more than put pretty Web sites up that tell people how well we are doing.

It is sad that we spend as much money as we spend on automation and yet cannot begin to accurately mimic what we demand the private sector do.

I hope today that as all of you testify—and I will be going between two subcommittee hearings of this whole committee—that you will bear in mind that if we are going to solve this problem we first have to, as Dwight David Eisenhower used to say, take a big problem and make it larger.

It is very clear that there is no central plan for an efficient and effective system of exchanging information within the Federal Government. That has been pervasive, as the acting GAO would tell us. It has been pervasive in our intel community. It has been a problem at DOD at all levels. And, of course, if we can't get it right we cannot work with our allies around the world to exchange information to keep America safe.

So although I consider this problem a huge problem, I would hope today that we begin to focus on the fact that unless there is a strategic plan to solve this problem through transparency and interoperability so that the roll-up of an organization, if today you are part of Homeland Security and tomorrow you are part of an entirely different Cabinet position, that it should be as transparency as simply saying this is now being redirected with a few strokes of the keys to another department. Today it would be hopeless to consider that. As a matter of fact, it would be a plan of probably 3 to 5 years in order to transition so that something could be done other than manually.

I have looked at your testimonies. I look forward to repeated followups. I would ask the Chairwoman that all Members, both present and those seated on the committee but not present today, have time to ask questions as followups to today's hearing and that they be answered in writing.

Ms. WATSON. Are you referring, Mr. Issa, to——

Mr. ISSA. To our witnesses.

Ms. WATSON. To the witnesses?

Mr. ISSA. That we be allowed to have followup, because their statements are very good and I think we are going to probe a long way into it, but, as is the custom of the committee, I would ask unanimous consent that all Members have the ability and that we get the acquiescence of the people testifying here today to take followup questions from any member of the committee.

Ms. WATSON. Mr. Issa, you know that is standard procedure, and without objection we will do that.

Mr. ISSA. Thank you, Madam Chair.

Ms. WATSON. Thank you for reminding us.

Mr. ISSA. It was not for the Chair. It was actually for the witnesses. Some of them are not used to getting a committee that looks at all of this and follows up with numerous questions, sometimes two and three times. Obviously, Mr. Dodaro is very familiar with it. But I asked for that reason.

Ms. WATSON. Well, let me reassure you, Mr. Issa, that we definitely will leave the record open, and we are open for your written testimony, as well as your written comments, as well as your response to Members' questions.

Again, thank you, Mr. Issa.

Mr. ISSA. Thank you, Madam Chair.

Ms. WATSON. Yes.

I now yield to Mr. Cooper for an opening statement.

Mr. COOPER. Thank you, Madam Chair.

This on the surface looks like a fairly small, inconsequential hearing. It is not. We are talking today about one of the most important issues that our entire Nation faces. As important as these auditing issues are, that is really not what is at stake here. What matters is the big picture, the aggregate, and I am worried that we missed the forest for the trees.

A lot of folks back home don't realize that the Federal Government is the last large entity left in America that refuses to use real accounting, so-called accrual accounting. In a business, if you can't measure it, you can't manage it. We in the Federal Government are refusing to use the real numbers, and it has been this way for a long, long time.

When David Walker was the Comptroller General he used to put explicitly in his Auditor's letter that the United States faced, back in his day, some $50 trillion in unfunded obligations. That number has grown. According to my staff's aggregate look at it, it is more like $62 trillion, and it is growing every day. It is growing by about $3 to $6 trillion a year.

These are promises that policymakers have made to Medicare recipients and Medicaid recipients and Social Security recipients, and we know today that we do not have enough money to make good these promises. So here we are in a situation in which every stockholder in America gets an annual report on their favorite company. It might be IBM. It might be some other company. But here we are as citizens, most of us don't even know there is an annual report for our favorite country, and most people are not going to the Treasury or GAO Web sites and downloading it.

Now, this year the report was shockingly late. It has been put out in past years on December 15th, and there are probably good reasons for a new administration to be slow getting it out. I still haven't seen a hard copy yet, and here we are well into 2010. But this is fundamental information if you care about the future of America. Moody's, Standard and Poor's, other rating agencies are already talking negatively about the future outlook of the U.S. Treasury bond, itself, what Moody's has called the anchor to the world's financial system.

We cannot risk a downgrade of the Treasury bond, but that is actually what is at stake. If you read the front page of USA Today yesterday, you saw shocking increase in debt, and that is actually using the conservative measure. If you look at what we are putting on the national credit card, not just in our cash account, it is even more frightening.

So the President, by Executive order, has appointed a fiscal responsibility commission, a bipartisan group to look into this. I am hoping and praying that people of goodwill on both parties, not only in Congress but across the country, will start paying more attention to these issues.

The hearing today on the financial report of the U.S. Government for 2009 is a good way to begin that debate, because these are the only real numbers available to average citizens to use real accounting to talk about our problems.

I am thankful that the statement of social insurance is audited. That is robust. That is ready for a robust public discussion.

So thank you, Madam Chair, for calling this hearing. This is a good way to begin.

Ms. WATSON. Thank you, Mr. Cooper.

I now yield to the gentleman from Virginia, Mr. Connolly.

Mr. CONNOLLY. Thank you, Madam Chairman. I thank you for holding these hearings and thank our panelists for being here.

Like Mr. Cooper, I think this really is a very important subject; however arcane for some, at least on the surface. Accounting is not always the most sensational of topics, and yet how we account for Federal spending, how we account for Federal budgeting actually is really critical to the fiscal health of the country as we move forward.

While I agree with my friend on much of what he had to say about accrual accounting and about making sure that there is transparency in what our obligations long-term are, I think it is important we not overstate the case. The Federal Government is not about to declare insolvency. Investments in Federal debt continue to be robust. And if you look at the out years in terms of the interest rate picture, it would suggest continuing confidence in the United States as an investor's safe haven.

That isn't to say that all is well, but it certainly is to suggest that the sky is not falling. We have some time. I think Mr. Cooper's words need to be taken to heart. We have some time to act. We have some time to make sure our fiscal house is brought into order once this recession is fully accounted for.

We had some good news this week. It looks like we are going to shave at least $300 billion off the projected debt—and that is good news—largely because of improved economic activity. It looks like the TARP program that was approved in the previous Congress and the previous administration actually may, at the most, have a net cost to taxpayers not of $700 billion originally appropriated, but of about $89 billion, and that is still counting. It may yet break even, or even turn a slight profit.

That is good news in terms of Federal spending and the taxpayer, but at the end of the day, as Mr. Cooper suggests, it is really about political will. It is about whether both sides are willing to suspend their respective theologies and look at the revenue picture and look at the spending picture in as much of an unbiased way as we can to try to make sure we are willing to put the tough decisions on the table and elect to act on some of them.

As a member of the Budget Committee, I am committed to certainly doing that as a deficit hawk, and I thank you, Madam Chairwoman, and my friend from Tennessee for constantly reminding us of the seriousness of this issue.

I look forward to the testimony.

Ms. WATSON. Thank you so much.

I want to have members of this committee rest assured that this is just part of a continuing group of hearings that will look at the efficacy of the way we spend money, the way we purchase, and the way we address our deficits. We are all keenly aware that we are in a deficit mode that will take years to recover from, recession. But there is a light at the end of the tunnel, even if it is a search party with a lantern. So we are going to try to get to the bottom and find ways to improve how we proceed.

With that said and no other Members present, we are going to proceed on with panel one.

Glad to see you, Mr. Cuellar. Would you have an opening statement, because we are going to be discussing your bill.

Mr. CUELLAR. Not right now.

Ms. WATSON. All right. Thank you very much.

It is the policy of the Committee on Oversight and Government Reform to swear in all witnesses before they testify, and I would like to ask all of you to please stand and raise your right hands.

[Witnesses sworn.]

Ms. WATSON. Let the record reflect that the witnesses answered in the affirmative.

I will now introduce each one of you on the panel.

First we have Gene L. Dodaro, the acting Comptroller General of the United States and the head of the Government Accountability Office, the investigative and auditing agency for Congress. Mr. Dodaro has held such a position as chief operating officer and the head of Government Accountability Office's accounting and information management division over the course of his distinguished career with the agency.

Next, Mr. Richard L. Gregg has served at the Department of Treasury with distinction for 36 years. He also is a Commissioner of the Financial Management Service for 9 years, and before that served as Commissioner of the Bureau of the Public Debt for 10 years. Mr. Gregg has also held numerous other management positions at Treasury during his long career.

Danny Werfel serves as the Controller of the Office of Federal Financial Management within the Office of Management and Budget, referred to as OMB. He oversees OMB's initiative to improve financial management across the Federal Government, including financial reporting and proper payments and real property management.

Mr. Werfel also develops the Federal Government's policies regarding fiscal accountability standards, grant management, and financial systems. He previously served OMB as Deputy Controller, Chief of the Fiscal Integrity and Analysis Branch, Budget Examiner in the Education Branch, and as Policy Analyst in the Office of Information and Regulatory Affairs.

James Millette is Deputy Assistant Secretary for Global Financial Services at the Department of State. He oversees the Resource Management Bureau, which includes integrated budget planning and performance. He also serves as the Deputy Assistant Secretary for Global Fiscal Services based in Charleston, South Carolina, which has an integrated fiscal service center in Bangkok and offices in Paris and Washington, DC, right here in the District. Previously, Mr. Millette was Deputy Assistant Secretary for State Programs, Operations, and Budget, as well as Senior Policy Advisor of the Chief Fiscal Officer.

And Mark E. Easton is the Primary Advisor to the Department of Defense, DOD, Controller, and Chief Financial Officer, and also serves as a senior staff member regarding all issues involving the amended CFO Act of 1990 and related financial management reforms. Mr. Easton is responsible at the Executive level for ensuring DOD's budget and financial execution in support of national security objectives, particularly in relation to finance and accounting policy, management, and controlled systems and general business transformation program.

He also oversees DOD's compliance with the Legislative and Executive financial management initiatives. Previously, Mr. Easton served as a Deputy Assistant Secretary of Navy and as Director for Financial Operations in the Office of the Assistant Secretary of the

Navy. In 2002 he retired as a captain in the Navy Supply Corps after serving for 29 years.

I want to thank all of you witnesses.

I ask that each of the witnesses now give a brief statement of your testimony, and keep your summary under 5 minutes in duration, if you can. Your complete written statement will be included in the hearing record.

We would like now to proceed with Mr. Dodaro.

STATEMENTS OF GENE L. DODARO, ACTING COMPTROLLER OF THE UNITED STATES; RICHARD L. GREGG, ACTING FISCAL ASSISTANT SECRETARY, U.S. DEPARTMENT OF TREASURY; DANNY WERFEL, CONTROLLER, OFFICE OF FEDERAL FINANCIAL MANAGEMENT, OFFICE OF MANAGEMENT AND BUDGET; JAMES L. MILLETTE, DEPUTY ASSISTANT SECRETARY FOR GLOBAL FINANCIAL SERVICES, DEPARTMENT OF STATE; AND MARK E. EASTON, DEPUTY CHIEF FINANCIAL OFFICER, DEPARTMENT OF DEFENSE

STATEMENT OF GENE L. DODARO

Mr. DODARO. Thank you very much, Madam Chairwoman, Congressman Schock, members of the subcommittee. I am very pleased to be here today to discuss GAO's report on the fiscal year 2009 consolidated final statements of the U.S. Government.

As has been mentioned in your opening comments, we did render an unqualified opinion on the statement of social insurance, and this is very important because the programs that it covers, Social Security and Medicare, are very important to understand the financial condition of the Federal Government and the sustainability of the commitments that have been made.

Unfortunately, as in past years, we have been unable to give an opinion on the accrual based financial statements of the Federal Government for a wide range of reasons, including serious financial management problems at the Department of Defense and the inability to eliminate inter-governmental transactions among Federal agencies.

As Congressman Issa mentioned, there are a lot of system problems that have also been noted in our audit reports. We have also, in the report, cited, as Congressman Schock mentioned, the almost $100 billion in improper payments that have been made, and there are pervasive information security problems with the Federal Government systems that need attended to. We made a number of recommendations. Actions are underway.

Now, our report also—and the report of the Government's financial statements—begins to shed some light on the affects of the recession on the Federal Government's finances, as well as the efforts that have been taken in order to deal with stabilizing our financial markets and stimulating economic growth. As a result, a lot of the transaction activity of the TARP program, of the American Recovery and Reinvestment Act are beginning to show up on the financial statements, but that story has not been told yet. There are a lot of uncertainties yet. There is a lot of money still to be spent under the Recovery Act, and so it will be important to follow through those activities in the coming years.

Now, it also, our report, talks about the long-term fiscal path of the Federal Government. We concluded, as has been mentioned today, and have concluded for a while that the Federal Government is on an unsustainable long-term fiscal path and action needs to be taken. As this chart shows and has been alluded to in your opening statements, under this simulation, which is based on past practices and policy preferences, the Federal Government debt held by the public within the next 10 years could exceed the historical high level as a percent of gross domestic product that was set back in World War II at 109 percent. Last year it was at 53 percent. This year it is approaching two-thirds of the gross domestic product annual deficit. But this is total debt held by the public.

Now, what does that mean in terms of the magnitude of the challenge? The next chart shows that by 2020, if you hold revenue constant at the 40-year average of 18.1 percent, the Federal Government would have enough revenue to pay for the net interest on the debt, Medicare, Medicaid, and Social Security, and would have to borrow the equivalent amount of money to pay for the entire rest of the operations of the Federal Government, including the Defense Department and Transportation, etc., going forward.

Now, the next chart shows, as Congressman Connolly mentioned, there is a window of opportunity to deal with this issue, but that window is rapidly closing. The first members of the Baby Boom generation, which are the creation of the demographic wave which is driving a lot of these changes, have already begun to apply for Social Security in 2008, 2 years ago. The Medicare trust fund is in a cash deficit situation.

In this fiscal year the Social Security system actually has negative cash influx. That was not expected to happen, but because of the recession and other things, so that the Social Security program had been making a net contribution to help reduce the borrowing cost of the Federal Government, that has changed temporarily. And within the next 6 years or so, it is estimated to have negative cashflows on a consistent and growing basis.

So action is urgently needed to begin to address this issue. I recognize the economy is still fragile. We need to keep an eye on that in the short term. But the Congress and the administration, the President, need to focus on coming up with a plan with the same intensity that they focused on in dealing with economic recovery and employment situations right now in order to address this issue.

I was very pleased to see the Congress pass the pay-go provisions, which will help deal with programs going forward to make sure they are funded for, but we have to deal with these legacy issues and the estimated commitments.

As Congressman Cooper mentioned, I was also pleased to see the President appoint the deficit commission. I think that is a very important step forward.

This concludes my statements.

I might note in my last chart, though, that we also, in addition to doing long-term simulations of the Federal Government, we also have begun doing simulations of the State and local sector. And the State and local sector is on the same ominous path of continual deficits that are large and growing. And this chart shows the solid line is the Federal Government's projections on annual deficits going forward. If you add the State and local sector to that, you get the dotted line. And so right now both the Federal Government and the State and local sector are under great fiscal stress.

I thank you for the opportunity to be here today, and I look forward to addressing your questions at the appropriate time.

[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 10:00 a.m. EDT
Wednesday, April 14, 2010

U.S. GOVERNMENT FINANCIAL STATEMENTS

Fiscal Year 2009 Audit Highlights Financial Management Challenges and Unsustainable Long-Term Fiscal Path

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

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Highlights

Highlights of GAO-10-483T, a testimony before the subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

GAO annually audits the consolidated financial statements of the U.S. government (CFS). Congress and the President need reliable, useful, and timely financial and performance information to make sound decisions and conduct effective oversight of federal government programs and policies.

The federal government began preparing the CFS 13 years ago. Over the years, certain material weaknesses in internal control over financial reporting have prevented GAO from expressing an opinion on the accrual-based consolidated financial statements. Unless these weaknesses are adequately addressed, they will, among other things, continue to (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 2009 and discusses certain of the federal government's significant near- and long-term fiscal challenges.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management. The federal government has generally taken or plans to take actions to address our recommendations.

View GAO-10-483T or key components. For more information, contact Jeanette M. Franzel or Gary T. Engel at (202) 512-2600 or Susan J. Irving at (202) 512-6806.

April 14, 2010

U.S. GOVERNMENT FINANCIAL STATEMENTS

Fiscal Year 2009 Audit Highlights Financial Management Challenges and Unsustainable Long-Term Fiscal Path

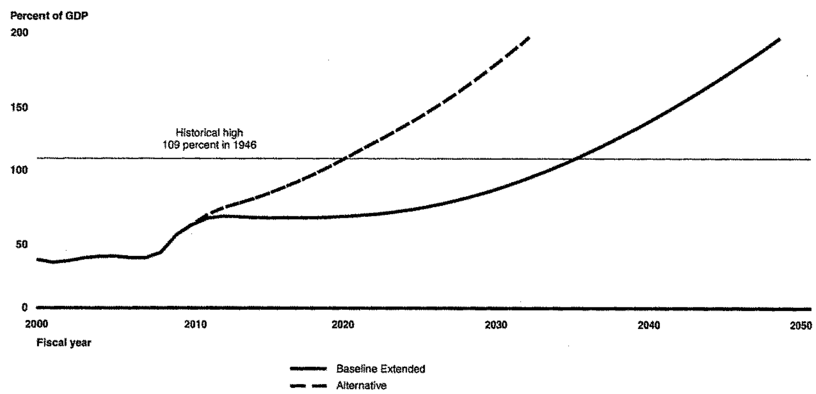
What GAO Found

For the third consecutive year, GAO rendered an unqualified opinion on the Statement of Social Insurance (SOSI). Given the importance of social insurance programs like Medicare and Social Security to the federal government's long-term fiscal outlook, the SOSI is critical to understanding the federal government's financial condition and fiscal sustainability. Three major impediments continued to prevent GAO from rendering an opinion on the federal government's consolidated financial statements other than the SOSI: (1) serious financial management problems at the Department of Defense, (2) federal entities' inability to adequately account for and reconcile intragovernmental activity and balances, and (3) an ineffective process for preparing the consolidated financial statements. In addition to the material weaknesses underlying these major impediments, GAO noted material weaknesses involving improper payments estimated to be at least $98 billion for fiscal year 2009, information security, and tax collection activities.

The recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery have significantly affected the federal government's financial condition. The resulting substantial investments and increases in liabilities, net operating cost, the unified budget deficit, and debt held by the public are reported in the U.S. government's consolidated financial statements for fiscal year 2009. The ultimate cost of these actions and their impact on the federal government's financial condition will not be known for some time in part because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently uncertain. Looking ahead, the federal government will need to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. In addition, problems in the nation's financial sector have exposed serious weaknesses in the current U.S. financial regulatory system. If those weaknesses are not adequately addressed, we could see similar or even worse crises in the future. Consequently, meaningful financial regulatory reform is of utmost concern.

The federal government faces a long-term fiscal challenge resulting from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. GAO prepares long-term fiscal simulations that include projections of revenue and expenditures for all federal programs. As a result, these simulations present a comprehensive analysis of the sustainability of the federal government's long-term fiscal outlook. Many of the pressures highlighted in GAO's simulations, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have previously served to reduce the unified budget deficit; however, the Congressional Budget Office recently estimated that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees' estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the federal budget. As shown in the figure, absent a change in policy, federal debt held by the public as a share of gross domestic product (GDP) could exceed the historical high reached in the aftermath of World War II by 2020—10 years sooner than GAO's simulation showed just 2 years ago. Although the economy is still fragile, there is wide agreement on the need to begin to change the long-term fiscal path as soon as possible without slowing the recovery because the magnitude of the changes required grows with time. Consequently, the administration and Congress will need to apply the same level of intensity to the nation's long-term fiscal challenge as they have to the recent economic and financial market issues. Congress recently enacted a return to statutory PAYGO and, in February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio. In addition, comprehensive long-term fiscal projections will be required in the federal government's financial statements beginning in fiscal year 2010, under a new accounting standard.

Debt Held by the Public Under Two Fiscal Policy Simulations



Source: GAO.

Madam Chairwoman, Ranking Member Bilbray and Other Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2009 and 2008. Given the federal government's near- and long-term fiscal challenges, the need for transparency and for Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information is greater than ever. As our report illustrates, however, even though certain progress has been made, much work remains to improve federal financial management. Consequently, financial management needs to be a top priority of this administration and Congress. I would like to commend you, Madam Chairwoman, and this Subcommittee, for continuing the annual tradition of oversight hearings on this important subject. Your involvement is critical to assuring progress.

Our testimony today discusses (1) the major issues relating to the consolidated financial statements for fiscal years 2009 and 2008, including continued major impediments to an opinion on the consolidated financial statements other than the Statement of Social Insurance;[1] (2) the impacts of the economic recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery on the federal government's financial condition; and (3) challenges posed by the federal government's current long-term fiscal outlook. Our audit was conducted in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.[2]

[1]The consolidated financial statements other than the Statement of Social Insurance are referred to as the accrual-based consolidated financial statements. Most revenues reported in these financial statements are recorded on a modified cash basis.

[2]Our work on the long-term fiscal outlook was conducted in accordance with all sections of GAO's Quality Assurance Framework that were relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

Both the consolidated financial statements and our related audit report are included in the fiscal year *2009 Financial Report of the United States Government (Financial Report)*. Our audit report would not be possible without the commitment and professionalism of inspectors general throughout the federal government who are responsible for annually auditing the financial statements of individual federal agencies. The *Financial Report* was issued by the Department of the Treasury (Treasury) on February 26, 2010.[3] This report is available through GAO's Internet site, at http://www.gao.gov/financial/fy2009financialreport.html and Treasury's Internet site, at http://www.fms.treas.gov/fr/index.html.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2009 and 2008

Since the enactment of key financial management reforms in the 1990s, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix I, 20 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their fiscal year 2009 financial statements. In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. 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, we were able to render unqualified opinions on the 2009, 2008, and 2007 Statements of Social Insurance.[4] Given the importance of social insurance programs like Medicare and Social Security to the federal government's long-term fiscal outlook, the Statement of Social Insurance is critical to understanding the federal government's financial condition and fiscal sustainability.

Although this progress is commendable, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain significant information reported in the U.S. government's accrual-based consolidated financial statements. Underlying material weaknesses

[3]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). In September 2009, we issued an update to this guide to reflect recent changes to the federal accounting standards and resulting changes to the *Financial Report*; see GAO-09-946SP (Washington, D.C.: September 2009).

[4]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.

in internal control,[5] which generally have existed for years,[6] contributed to our disclaimer of opinion on the U.S. government's accrual-based consolidated financial statements for the fiscal years ended 2009 and 2008.[7] Those material weaknesses relate to 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 accrual-based consolidated financial statements;
- 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 federal entities;
- adequately account for and reconcile intragovernmental activity and balances between federal entities;
- ensure that the federal government's accrual-based consolidated financial statements were (1) consistent with the underlying audited entities' financial statements, (2) properly balanced, and (3) in conformity with U.S. generally accepted accounting principles (GAAP); and
- identify and either resolve or explain material differences between certain components of the budget deficit reported in Treasury's records, which are used to prepare the Reconciliation of Net Operating

[5]A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A deficiency in internal control 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 and correct misstatements on a timely basis.

[6]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 and on the accrual-based consolidated financial statements of the U.S. government for fiscal years 2007 and 2008.

[7]A more detailed description of the material weaknesses that contributed to our disclaimer of opinion, including the primary effects of these material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 224 through 230 of the *Financial Report*.

Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal entities' financial statements and underlying financial information and records.

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, we found three other material weaknesses in internal control.[8] These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments,[9]
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

The material weaknesses discussed in our audit report continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (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; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an efficient and effective manner.

Also, many of the CFO Act agencies continue to struggle with financial systems that are not integrated and do not meet the needs of management for reliable, useful, and timely financial information. Often, agencies expend major time, effort, and resources to develop information that their systems should be able to provide on a daily or recurring basis.

[8] A more detailed discussion of these weaknesses, including the primary effects of the material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 231 through 233 of the *Financial Report*.
[9] Federal entities reported estimates of improper payment amounts that totaled $98.7 billion for fiscal year 2009, which represented about 5 percent of $1.9 trillion of reported outlays for the related programs.

Addressing Impediments to an Opinion on the Accrual-Based Consolidated Financial Statements

Three major impediments continued to prevent us from rendering an opinion on the U.S. government's accrual-based consolidated financial statements: (1) serious financial management problems at DOD that have prevented DOD's financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Additional impediments, such as certain entities' fiscal year 2009 financial statements that, as of the date of our audit report, received disclaimers of opinion or were not audited, also contributed to our inability to render an opinion on the U.S. government's accrual-based consolidated financial statements. Extensive efforts by DOD and other entity officials and cooperative efforts between entity chief financial officers, Treasury officials, and Office of Management and Budget (OMB) officials will be needed to resolve these obstacles to achieving an opinion on the U.S. government's accrual-based consolidated financial statements.

Improving Financial Management at DOD

Given DOD's significant size and complexity, the resolution of its serious financial management problems is an essential element in further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements. Reported weaknesses in DOD's financial management and other business operations adversely affect the reliability of DOD's financial data; the economy, efficiency, and effectiveness of its operations; and its ability to produce auditable financial statements. DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement.[10] Eight of the high-risk areas are specific to DOD and include DOD's overall approach to business transformation, and financial and contract management.

To effectively transform its business operations, DOD management must have reliable financial information. Without it, DOD is severely hampered in its ability to make sound budgetary and programmatic decisions, monitor trends, make adjustments to improve performance, reduce operating costs, or maximize the use of resources.[11]

[10]GAO, *High-Risk Series: An Update*, GAO-09-271 (Washington, D.C.: January 2009).

[11]Gene L. Dodaro, "Maximizing DOD's Potential to Face New Fiscal Challenges and Strengthen Interagency Partnerships." Presented before the National Defense University, Washington, D.C., January 6, 2010.

DOD continues to take steps toward addressing the department's long-standing financial management weaknesses. The current DOD Comptroller's focus on improving the department's budgetary information and asset accountability will result in a change in emphasis within the Financial Improvement and Audit Readiness (FIAR) Plan, DOD's plan for improving its financial management. The emphasis is now on two areas—first, strengthening information and processes supporting the department's Statements of Budgetary Resources; and second, improving the accuracy and reliability of management information pertaining to the department's mission-critical assets, including weapons systems, real property, and general equipment, and validating improvement through existence and completeness testing.

Budgetary and asset-accountability information is widely used by DOD managers at all levels. As such, its reliability is vital to daily operations and management. In this regard, the Marine Corps recently began an audit of its fiscal year 2010 Statement of Budgetary Resources. DOD intends to share with the other services the approaches and lessons learned from the Marine Corps audit.

A concentrated focus such as the DOD Comptroller's emphasis on budget and asset information may increase the department's ability to show incremental progress toward achieving auditability in the short term. In response to GAO's recommendations, the department has also put in place a process to improve standardization and comparability of financial management improvement efforts among the military services. The success of this process will depend on top management support and oversight, as well as high-quality planning and effective implementation at all levels.

The National Defense Authorization Act for Fiscal Year 2010 (NDAA)[12] lists corrective and improvement actions that DOD is required to take in developing and implementing the FIAR Plan. Consistent with recommendations we made in May 2009 regarding DOD's FIAR Plan,[13] the NDAA requires DOD to

[12]Pub. L. No. 111-84, Div. A, title X § 1003, 123 Stat. 2190, 2439-2441 (Oct. 28, 2009).

[13]GAO, *Financial Management: Achieving Financial Statement Auditability in the Department of Defense*, GAO-09-373 (Washington, D.C.: May 6, 2009).

- develop standardized guidance for financial improvement plans by components of the department;
- establish a baseline of financial management capabilities and weaknesses at the component level;
- provide results-oriented metrics for measuring and reporting quantifiable results toward addressing financial management deficiencies;
- define the oversight roles of the Chief Management Officer (CMO) of the department, the CMOs of the military services, and other appropriate elements of the department to ensure that the FIAR requirements are carried out;
- assign to appropriate officials and organizations at the component level accountability for carrying out specific elements of the FIAR Plan;
- develop mechanisms to track budgets and expenditures for implementation of the FIAR requirements; and
- develop a mechanism to conduct audits of the military intelligence programs and agencies and submit the audited financial statements to Congress in a classified manner.

We are encouraged by continuing congressional oversight of DOD's business transformation and financial management improvement efforts and the commitment of DOD's leaders to implementing sustained improvements in the department's ability to produce reliable, useful, and timely information for decision making and reporting. We will continue to monitor DOD's progress in addressing its financial management weaknesses and transforming its business operations. As part of this effort, we are also monitoring DOD's specific actions to achieve financial statement auditability for its components.

Reconciling Intragovernmental Activity and Balances

Federal entities are unable to adequately account for and reconcile intragovernmental activity and balances. For both fiscal years 2009 and 2008, amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. Although OMB and Treasury require the CFOs of 35 federal entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners, a substantial number of the entities did not adequately perform those reconciliations for fiscal years 2009 and 2008.

In addition, these entities are required to report to Treasury, the entity's inspector general, and GAO on the extent and results of intragovernmental activity and balance-reconciliation efforts as of the end of the fiscal year. A significant number of CFOs were unable to adequately explain or support the material differences with their trading partners. Many 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 as to when the differences would be resolved. As a result of these circumstances, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

GAO has identified and reported on numerous intragovernmental activities and balances issues and has made several recommendations to Treasury and OMB to address those issues. Treasury and OMB have generally taken or plan to take actions to address these recommendations. Treasury continues to take steps to help resolve material differences in intragovernmental activity and balances. For example, beginning in the third quarter of 2009, Treasury required entities to perform additional reconciliations related to certain intragovernmental appropriations and transfer activity. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal entities to fully implement guidance regarding business rules for intragovernmental transactions issued by OMB and Treasury as well as continued strong leadership by OMB and Treasury.[14]

Preparing the Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2009, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with GAAP.[15] For example,

[14]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.

[15]Most of the issues we identified in fiscal year 2009 existed in fiscal year 2008, and many have existed for a number of years. In April 2009, we reported the issues we identified to Treasury and OMB and provided recommendations for corrective action in GAO, *Financial Audit: Material Weaknesses in Internal Control Continue to Impact Preparation of the Consolidated Financial Statements on the U.S. Government*, GAO-09-387 (Washington, D.C.: Apr. 21, 2009). We also reported that as of December 9, 2008, the date of our report on our audit of the fiscal year 2008 consolidated financial statements, 16 of the 56 open recommendations from the previous years' audits had been closed.

- Treasury's process did not ensure that the information in the Statement of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Unified Budget Deficit, and Statements of Changes in Cash Balance from Unified Budget and Other Activities was fully consistent with the underlying information in federal entities' audited financial statements and other financial data.

- To make the fiscal years 2009 and 2008 consolidated financial statements balance, Treasury recorded net increases of $17.4 billion and $29.8 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Unmatched transactions and balances."[16] An additional net $8 billion and $11 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2009 and 2008, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- Treasury's reporting of certain financial information required by GAAP continues to be impaired. Due to certain material weaknesses noted in our audit report—for example, commitments and contingencies related to treaties and other international agreements—Treasury is precluded from determining if additional disclosure is required by GAAP in the consolidated financial statements, and we are precluded from determining whether the omitted information is material. Further, Treasury's ability to report information in accordance with GAAP will also remain impaired until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

A detailed discussion of additional control deficiencies regarding the process for preparing the consolidated financial statements can be found on pages 226 through 229 of the *Financial Report*.

During fiscal year 2009, Treasury, in coordination with OMB, continued implementing corrective action plans and made progress in addressing certain internal control deficiencies we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control deficiencies will be a difficult challenge and

[16]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.

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

Addressing Other Impediments

While not as significant as the major impediments noted above, financial management problems at the Department of Homeland Security (DHS), the National Aeronautics and Space Administration (NASA), and the Department of State (State) also contributed to the disclaimer of opinion on the federal government's accrual-based consolidated financial statements for fiscal year 2009. About $48 billion, or about 2 percent, of the federal government's reported total assets as of September 30, 2009, and approximately $101 billion, or about 3 percent, of the federal government's reported net cost for fiscal year 2009 relate to these three agencies. According to auditors for DHS, NASA, and State, these agencies continue to have reported material weaknesses in internal control. While the auditors for DHS and NASA noted certain progress in financial reporting, each of the three agency auditors also reported that they were unable to provide opinions on the financial statements because they were not able to obtain sufficient evidential support for amounts presented in certain financial statements. For example,

- only selected DHS financial statements were subjected to audit, and the auditors stated that DHS was unable to provide sufficient evidence to support certain financial statements balances at the Coast Guard and Transportation Security Administration;
- auditors for NASA identified issues related to internal control in its property accounting, principally relating to assets capitalized in prior years; and
- auditors for State reported that the department was unable to provide sufficient support for the amounts presented in the fiscal year 2009 Combined Statement of Budgetary Resources and the property and equipment balance.

The auditors for DHS, NASA, and State made recommendations to address control deficiencies at the agencies, and management for these agencies generally expressed commitment to resolve the deficiencies. It will be important that management at each of these agencies remain committed to addressing noted control deficiencies and improving financial reporting.

Impacts of the Recession and Stabilization Efforts on the Federal Government's Financial Condition

The federal government reported a net operating cost of $1.3 trillion and a unified budget deficit of $1.4 trillion for fiscal year 2009, significantly higher than the amounts in fiscal year 2008. As of September 30, 2009, debt held by the public increased to 53 percent of gross domestic product (GDP). These increases are primarily the result of the effects of the recession and the costs of the federal government's actions to stabilize the financial markets and to help promote economic recovery.

In December 2007, the United States entered what has turned out to be its deepest recession since the end of World War II. Between the fourth quarter of 2007 and the third quarter of 2009, GDP fell by about 2.8 percent. The nation's unemployment rate rose from 4.9 percent in 2007 to 10.2 percent in October 2009, a level not seen since April 1983. Federal tax revenues automatically decline when GDP and incomes fall, and at the same time, spending on unemployment benefits and other income-support programs automatically increases.

As of September 30, 2009, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in an increase in reported federal assets of over $500 billion (e.g., Troubled Asset Relief Program (TARP) equity investments, and investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and mortgage-backed securities guaranteed by them), which is net of about $80 billion in valuation losses. In addition, the federal government reported incurring additional significant liabilities (e.g., liquidity guarantees to Fannie Mae and Freddie Mac) and related net cost resulting from these actions. Because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions, actual results may be materially different from the reported amounts.

In addition, the federal government's financial condition will be further affected as its actions continue to be implemented in fiscal year 2010 and later. For example, several hundred billion dollars of the total estimated $862 billion cost under the American Recovery and Reinvestment Act of

2009 (Recovery Act)[17] remain to be disbursed.[18] Also, continued implementation of TARP,[19] which was extended through October 3, 2010, is likely to result in additional cost, and the Federal Housing Administration (FHA) mortgage guarantee program could result in additional cost. Consequently, the ultimate cost of the federal government's actions and their effect on the federal government's financial condition will not be known for some time.

Further, there are risks that the federal government's financial condition could be affected in the future by other factors, including the following:

- Several initiatives undertaken in 2009 by the Federal Reserve to stabilize the financial markets have led to a significant change in the reported composition and size of the Federal Reserve's balance sheet, including the purchase of over $900 billion in mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association as of the end of 2009. If the Federal Reserve sells these securities at a loss, additional federal government deposits at the Federal Reserve may be needed, future payments of Federal Reserve earnings to the federal government may be reduced, or both.[20]
- Although the Recovery Act provided some fiscal relief to the states, expected continued state fiscal challenges could place pressure on the federal government to provide further relief to them.

Looking ahead, the federal government will need to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. In addition to managing these actions, problems in the nation's financial sector have exposed serious weaknesses in the current U.S. financial regulatory system, which, if not effectively addressed, may cause the system to fail to prevent similar or even worse crises in the future. The current system, which was put into place over the past 150 years, is fragmented and complex and simply has

[17]Pub. L. 111-5, 123 Stat. 115 (Feb. 17, 2009).

[18] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (Washington, D.C.: January 2010).

[19]GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, GAO-10-301 (Washington, D.C.: Dec. 9, 2009).

[20]Under Federal Reserve System policy, Federal Reserve bank earnings in excess of statutory dividends to member banks are paid to the federal government. The federal government received about $34 billion of such payments in fiscal year 2009.

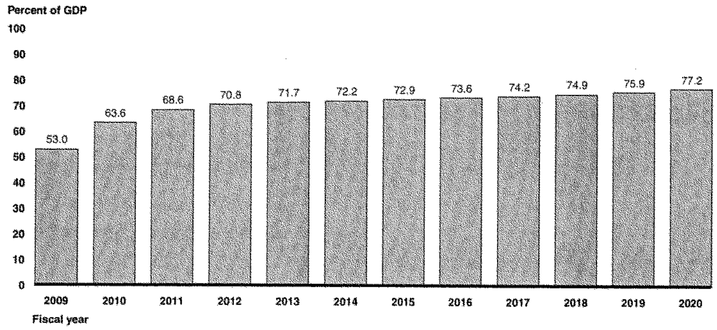
not kept pace with the major financial structures, innovations, and products that emerged during the years leading up to the recent financial crisis. Consequently, meaningful financial regulatory reform is of utmost concern. In crafting and evaluating proposals for financial regulatory reform, it will be important for Congress and others to be mindful of the need to use a framework that facilitates a comprehensive assessment of the relative strengths and weaknesses of each proposal. GAO has previously set forth such a framework that involves nine key elements that are critically important in establishing the most effective and efficient financial regulatory system possible: (1) clearly defined regulatory goals; (2) appropriately comprehensive; (3) systemwide focus; (4) flexible and adaptive; (5) efficient and effective; (6) consistent consumer and investor protection; (7) regulator provided with independence, prominence, authority, and accountability; (8) consistent financial oversight; and (9) minimal taxpayer exposure.[21]

The Near- and Long-Term Fiscal Challenges

The economic downturn and the nature and magnitude of the actions taken to stabilize the financial markets and to promote economic recovery will continue to shape the federal government's near-term budget and debt outlook. Actions taken to stabilize financial markets—including aid to the automotive industry—increased borrowing and added to the federal debt. The revenue decreases and spending increases enacted in the Recovery Act also added to borrowing and debt. As shown in figure 1, the President's budget projects debt held by the public growing from 53.0 percent of GDP in fiscal year 2009 to 63.6 percent by the end of fiscal year 2010 and 68.6 percent by the end of fiscal year 2011. While deficits are projected to decrease as federal support for states and the financial sector winds down and the economy recovers, the increased debt and related interest costs will remain.

[21]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

Figure 1: Debt Held by the Public Under the President's Fiscal Year 2011 Budget



Source: Office of Management and Budget.

Note: The data are from *Budget of the United States Government, Fiscal Year 2011: Summary Tables.*

Further, all of this takes place in the context of the current long-term fiscal outlook. The federal government faced large and growing structural deficits—and hence rising debt—before the instability in financial markets and the economic downturn. While the drivers of the long-term fiscal outlook have not changed, the sense of urgency has. As table 1 shows, many of the pressures highlighted in GAO's simulations, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have previously served to reduce the unified budget deficit; however, the Congressional Budget Office (CBO) recently estimated that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees' estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the federal budget. With the passage of time the window to address this challenge narrows.

Table 1: Pressures on the Federal Budget in the Near Term

2008	Oldest members of the baby-boom generation became eligible for early Social Security retirement benefits
2008	Medicare Hospital Insurance (HI) outlays exceeded cash income
2010	Social Security runs first cash deficit since 1984[a]
2011	Oldest members of the baby-boom generation become eligible for Medicare
2014	45 percent of Medicare outlays funded by general revenue[b]
2016	Social Security begins running consistent annual cash deficits
2017	Medicare HI trust fund exhausted. Income sufficient to pay about 81 percent of benefits[b]
2020	Debt held by the public under GAO's Alternative simulation exceeds the historical high reached in the aftermath of World War II

Source: GAO analysis.

[a]Based on CBO's January 2010 baseline projections.

[b]Based on *2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (May 12, 2009). Projections showing the percentage of funding from general revenue reaching 45 percent by law trigger a "Medicare funding warning," requiring a proposal from the President in response.

The federal government is on an unsustainable long-term fiscal path driven on the spending side primarily by rising health care costs and known demographic trends. The Statement of Social Insurance, for example, shows that the present value of projected scheduled benefits exceed earmarked revenues for social insurance programs (e.g., Social Security and Medicare) by approximately $46 trillion[22] over the 75-year period. Since GAO's long-term fiscal simulations include projections of revenue and expenditures for all federal programs, they present a comprehensive analysis of the sustainability of the federal government's long-term fiscal outlook. Figures 2, 3, and 4 show the results of our most recent long-term fiscal simulations that were issued in March 2010.[23]

Absent a change in policy, federal debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World

[22]On an open group basis (current and future participants).

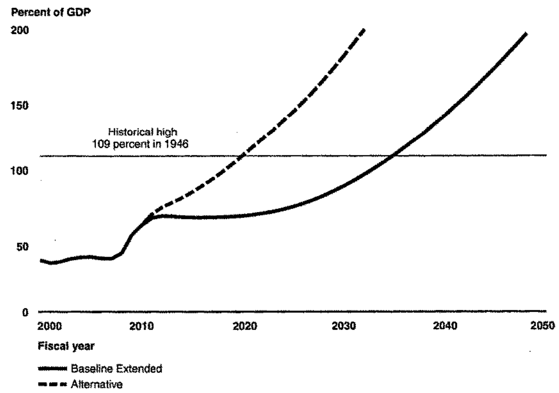
[23]GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, GAO-10-468SP (Washington, D.C.: March 2010).

War II by 2020 (see fig. 2)[24] —10 years sooner than our simulation showed just 2 years ago. As a result, the administration and Congress will need to apply the same level of intensity to the nation's long-term fiscal challenge as they have to the recent economic and financial market issues. Although the economy is still fragile, there is wide agreement on the need to begin to change the long-term fiscal path as soon as possible without slowing the recovery because the magnitude of the changes required grows with time. Congress recently enacted a return to statutory PAYGO—a budgetary control requiring that the aggregate impact of increases in mandatory spending or reductions in revenue generally be offset.[25] Although this can prevent further deterioration of the fiscal position, it does not deal with the existing imbalance. In February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio.

[24]This is under GAO's January 2010 Alternative simulation, which assumes discretionary spending other than the Recovery Act provisions grows with GDP after 2010; the Recovery Act provisions are included but assumed to be temporary. Expiring tax provisions are extended and the 2009 Alternative Minimum Tax exemption amount is indexed to inflation through 2020. After 2020, revenue as a share of GDP is brought to its 40-year historical average of 18.1 percent of GDP. Medicare spending is adjusted based on the assumption that physician fees are not reduced as specified under current law.

[25]For details on the rules governing the implementation of PAYGO, see Public Law 111-139.

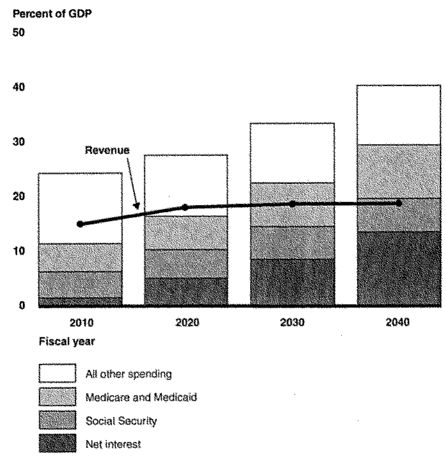
Figure 2: Debt Held by the Public Under Two Fiscal Policy Simulations



Source: GAO.

Note: Information presented for fiscal years 2000 through 2009 is based on historical data and for fiscal years 2010 through 2050 is derived from fiscal policy simulations. See GAO-10-468SP.

Figure 3: Revenues and Composition of Spending as Shares of GDP Under GAO's Alternative Simulation



Source: GAO.
Note: Data from GAO's January 2010 analysis based on the Trustees' assumptions for Social Security and Medicare. See GAO-10-468SP.

One quantitative measure of the long-term fiscal challenge is called the "fiscal gap." The fiscal gap is the amount of spending reductions or tax increases, over a certain time period such as 75 years, that would be needed to keep debt as a share of GDP at or below today's ratio. 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 2. 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, or some combination of the two averaging 9.0 percent of the entire economy over the next 75 years, or about $76.4 trillion in present value terms. To put this in perspective, closing the gap solely through revenue increases would require annual increases in federal tax revenues of about 50 percent on average, or to do it solely through spending reductions would require annual reductions in federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) of about 34 percent on average over the entire 75-year period.

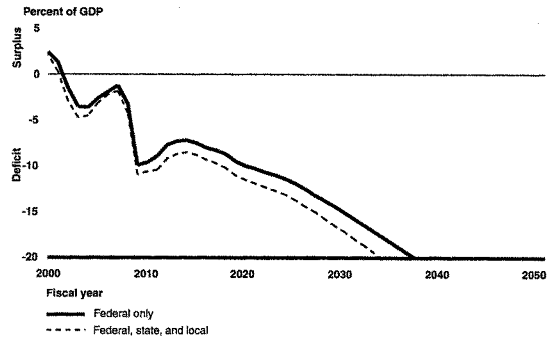
Policymakers could phase in policy changes so that tax increases or spending cuts or both would grow over time allowing time for the economy to recover and for people to adjust to the changes. However, the longer action to deal with the long-term outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

Comprehensive long-term fiscal projections will be required in the federal government's financial statements beginning in fiscal year 2010, under a new accounting standard.[26] Such reporting will include information about the long-term fiscal condition of the federal government and annual changes therein, and will expand upon the information currently provided in the Management's Discussion and Analysis section of the *Financial Report*.

It is not only the federal government that faces a long-term fiscal challenge. Figure 4 shows the federal and combined federal, state, and local surpluses and deficits as a share of GDP from our most recent simulation results.[27]

[26]Statement of Federal Financial Accounting Standards (SFFAS) No. 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government* (Washington, D.C.: Sept. 28, 2009).
[27]See GAO, *State and Local Governments' Fiscal Outlook: March 2010 Update*, GAO-10-358 (Washington, D.C.: Mar. 2, 2010).

Figure 4: Federal and Combined Federal, State, and Local Surpluses and Deficits



Source: GAO.

Note: Information presented for fiscal years 2000 through 2009 is based on historical data and for fiscal years 2010 through 2040 is derived from fiscal policy simulations. The federal data are from GAO's Alternative simulation.

Closing Comments

In closing, even though progress has been made in improving federal financial management activities and practices, much work remains given the federal government's near-and long-term fiscal challenges and the need for Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information to effectively meet these challenges.

The need for such information and transparency in financial reporting is clearly evident. The recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery have significantly affected the federal government's financial condition, especially with regard to certain of its investments and increases in its liabilities and net operating cost. Importantly, while such increases are reported in the U.S. government's consolidated financial statements for fiscal year 2009, the valuation of certain assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions. Going forward, a great amount of attention will need to be devoted to ensuring (1) that sufficient internal controls and transparency are established and maintained for all financial stabilization and economic recovery initiatives; and (2) that all related financial transactions are reported on time, accurately, and completely.

Further, sound decisions on the current and future direction of all vital federal government programs and policies are more difficult without reliable, useful, and timely financial and performance information. In this regard, for DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses and its efforts to achieve auditability. Consistent and diligent top management oversight toward achieving financial management capabilities, including audit readiness, will be needed. Moreover, 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. Federal entities need to improve the government's financial management systems to achieve this goal.

Moreover, of utmost concern are the federal government's long-term fiscal challenges that result from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. This unsustainable path must be addressed soon by policymakers.

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 the top leadership of federal entities accountable for resolving the remaining problems and that they support improvement efforts.

Madam Chairwoman and Ranking Member Bilbray, 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 Jeanette M. Franzel, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600, as well as Susan J. Irving, Director, Federal Budget Analysis, Strategic Issues, at (202) 512-6806. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Fiscal year 2009 Audit Results

Table 2: Chief Financial Officers (CFO) Act Agencies: Fiscal Year 2009 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	√	Office of Inspector General (OIG)
Agriculture	Unqualified	√	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		KPMG LLP
Health and Human Services	Unqualified	√	Ernst & Young, 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		Urbach Kahn & Werlin LLP
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		OIG
State	[c]	√	Kearney & Company
Transportation	Unqualified	√	Clifton Gunderson LLP
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 2009, 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.

[c]The auditors disclaimed an opinion on the Department of State's fiscal year 2009 Statement of Budgetary Resources and rendered a qualified opinion on State's Consolidated Balance Sheet and the related Statements of Net Cost and Changes in Net Position.

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May 11, 2010

The Honorable Diane E. Watson
Chairwoman
Subcommittee on Government Management,
Organization, and Procurement
Committee on Oversight and Government Reform
House of Representatives

The Honorable Darrell E. Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

Subject: *Responses to Posthearing Questions Related to GAO's Testimony on the U.S. Government's Consolidated Financial Statements for Fiscal Year 2009*

On April 14, 2010, I testified before the Subcommittee on Government Management, Organization, and Procurement, House Committee on Oversight and Government Reform, at a hearing on GAO's report related to the U.S. government's consolidated financial statements for fiscal year 2009.[1] This letter responds to a request for written responses to questions received from you following that hearing. The questions and our responses follow.

Responses to Chairwoman Watson's Questions for the Record

Question One: GAO has frequently cited the federal government's ineffective process for preparing the consolidated financial statements as a major impediment that precludes the issuance of an audit opinion.

- **When do you anticipate that this material weakness will be resolved and no longer cited in U.S. Government reports?**
- **Which agencies have been relatively more successful in dealing with this challenge?**
- **What have they done differently, and could their experiences be used to better address this problem in other agencies?**

[1]GAO, *U.S. Government Financial Statements: Fiscal Year 2009 Audit Highlights Financial Management Challenges and Unsustainable Long-Term Fiscal Path*, GAO-10-483T (Washington, D.C: Apr. 14, 2010).

The timing on when the material weakness related to the process of preparing the U.S. government's consolidated financial statements (CFS) will be resolved depends upon effective implementation of corrective measures by federal agencies, both governmentwide and at certain individual agencies. For several years, GAO has reported the federal government's ineffective process for preparing the CFS as a material weakness[2] contributing to our disclaimer of opinion on the consolidated financial statements, other than the Statement of Social Insurance. Underlying control deficiencies exist at both the governmentwide and agency levels.

Governmentwide, we have continued to report that the federal government had inadequate systems, controls, and procedures to ensure that the CFS are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles. A detailed discussion of these issues can be found on pages 226 through 229 of the *2009 Financial Report of the United States Government*.[3] Over the years, we have made several recommendations to the Department of the Treasury (Treasury) and the Office of Management and Budget (OMB) for corrective actions in this area. During fiscal year 2009, Treasury, in coordination with OMB, continued implementing corrective action plans and made progress in addressing certain of the control deficiencies regarding the preparation process for the CFS; however, many of our recommendations continued to remain open in fiscal year 2009. This long-standing material weakness will not be resolved until the underlying control deficiencies are adequately addressed. To do such will require a strong and sustained commitment by federal entity leadership and continued strong leadership by Treasury and OMB. We will continue to monitor Treasury's and OMB's actions and report on the status of their progress in our future audits.

Control problems in the financial reporting processes at certain agencies also contributed to the material weakness regarding the federal government's ineffective process for preparing the CFS. For fiscal year 2009, auditors for many of the Chief Financial Officers (CFO) Act agencies[4] continued to report control deficiencies regarding the agencies' financial reporting processes, which in turn, could affect the preparation of the CFS. For example, auditors for several entities reported that a significant number of adjustments were required to prepare the entities' financial statements. Many of the CFO Act agencies continue to struggle with financial systems

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[2]A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A deficiency in internal control 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 and correct, misstatements on a timely basis.

[3]The *2009 Financial Report of the United States Government*, issued by the Department of the Treasury on February 26, 2010, is available through GAO's Web site at http://www.gao.gov/financial/fy2009financialreport.html and Treasury's Web site at http://www.fms.treas.gov/fr/index.html.

[4]The 24 CFO Act agencies are listed at 31 U.S.C. § 901(b).

that are not integrated and do not meet the needs of management for reliable, useful, and timely financial information.

Some federal entities appear to have been relatively more successful than others at establishing adequate financial reporting processes. For example, for fiscal year 2009, several CFO Act agencies' auditors, including those for the Social Security Administration, Department of Energy, and Department of Commerce, did not report material weaknesses or significant deficiencies in financial reporting for the respective agencies. In addition, the auditors reported that the results of their tests did not disclose instances in which these agencies' financial management systems were not in substantial compliance with the Federal Financial Management Improvement Act[5] (FFMIA) requirements, which include having integrated financial management systems[6] that can be used to help manage agency programs more effectively and enhance their ability to prepare auditable financial statements. We have not specifically evaluated actions taken by these federal entities to achieve these accomplishments in financial reporting; however, effective financial reporting relies heavily on the ability of the entity financial management systems to produce reliable, useful, and timely financial information.

Question Two: In testimony before this subcommittee last summer, you expressed concern about the January 9, 2009 revision of OMB's Circular No. A-127, *Financial Management Systems*, noting that the revised circular "substantially reduces the scope and rigor of compliance testing for agency financial management systems, omits compliance with the Standard General Ledger from the compliance indicators, and eliminates the existing federal financial systems for the financial portion of mixed systems."

- **How have implementation efforts by the agencies during the first six months served to substantiate or mitigate these concerns?**

OMB Circular No. A-127, revised on January 9, 2009,[7] was not effective until October 1, 2009. Therefore, it is too soon to evaluate the impact of the revised circular. However, as discussed below, OMB will be revising OMB Circular No. A-127 due to recent changes in the approach for modernizing federal financial systems and the closing of the Financial Systems Integration Office (FSIO). We will continue to monitor OMB's actions in this area and the resulting impact.

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[5]Federal Financial Management Improvement Act (FFMIA) of 1996, Pub. L. No. 104-208, div. A., § 101(f), title VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996). FFMIA requires the CFO Act agencies to implement and maintain financial management systems, that comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the *U.S. Government Standard General Ledger* at the transaction level.

[6]The term financial management systems includes the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

[7]OMB Circular No. A-127 (revised), *Financial Management Systems* (Washington, D.C.: Jan. 9, 2009) prescribes policies and standards for executive departments and agencies to follow concerning their financial management systems.

- **How might the closing of the Financial Systems Integration Office further affect agency compliance with FY 2010 financial reporting requirements?**

Because OMB has not yet developed a new approach for improving federal financial management systems, it is not clear how the closing of FSIO would affect fiscal year 2010 reporting requirements. In its March 16, 2010, memorandum, "Update on the Financial Systems Integration Office," OMB announced that FSIO had achieved its objectives of developing governmentwide financial management business processes and data elements and that FSIO would cease operations effective March 31, 2010. OMB had also reassessed the need for the core financial systems testing and product certification program that had been performed by FSIO and had discontinued this function. OMB also stated that rapid advances in technology are requiring a new approach to implementing financial systems. OMB further stated in the memo that it will be communicating the impact of these changes to compliance requirements (e.g., OMB Circular No. A-127) in the future. However, OMB has not yet developed the details of this new approach and its impact on the federal government's strategy for improving financial management systems remains unclear. We will continue to monitor OMB's actions in this area and the resulting impact.

Question Three: OMB recently issued guidance for the implementation of Executive Order 13520, "Reducing Improper Payments."

- **What impact do you think these additional tools will likely have on efforts not only to reduce, but to prevent future improper payments?**

Executive Order 13520 established requirements for transparency, accountability, and incentives, which are long-standing management concepts that could prove fruitful for addressing the challenge of reducing improper payments. We view the activities called for in OMB's implementing guidance as positive steps to improving transparency and reducing improper payments in the future.

The executive order focuses on increasing transparency (e.g., establish a Web site with improper payment data), holding entities accountable (e.g., appoint an accountable agency official), and creating incentives (e.g., identify incentives for state and local governments to reduce improper payments involving federal funds). The executive order directed the creation of work groups to address the areas of focus and provide recommendations by May 2010. OMB issued guidance for implementing the executive order in March 2010. This implementing guidance established additional requirements for agencies to report information, including improper payment error rates, estimated amounts, and improper payment causes, as well as targets for reducing and recovering improper payments. Agencies are required to submit the improper payment information to a Web-based data repository known as the Dashboard.

Moving forward, it will be critical for continued focus at the highest management levels to reduce improper payments. Leadership and guidance from the administration is needed to ensure that action plans are developed to address the workgroups' recommendations and appropriate resources are directed at reducing improper payments in the government's high priority programs. Success will also depend on each agency's diligence and commitment to identify, estimate, determine the causes of, take corrective actions on, measure, and report progress in reducing improper payments. The level of importance the agencies and the administration place on the efforts to implement the executive order will determine its overall effectiveness to reduce improper payments and ensure that federal funds are used efficiently and for their intended purposes.

Question Four: GAO has recommended that OMB take action to ensure that smaller programs with higher risk are covered by the Single Audit Act.

- **Are you satisfied with OMB's response to this recommendation, including through its updated American Recovery and Reinvestment Act, or ARRA guidance which was issued on March 22, 2010?**

OMB took several short-term actions to address our recommendation. Specifically, OMB's May and August 2009 guidance called for clustering similar Recovery Act programs together. As a result of this approach, the combined amounts of federal expenditures for the cluster are added together to make it more likely that the program cluster would be selected as a major program for consideration for single audit. The May and August 2009 guidance, among other things, also stated that the Recovery Act-funded programs should be considered to have elevated risk levels for consideration in the single audit process. Specifically, the guidance required that the auditor consider all federal programs with expenditures of Recovery Act awards to be programs of higher risk.

For 2010, OMB has stated that it would address specific Recovery Act-related compliance requirements in the 2010 Compliance Supplement, which OMB anticipates will be issued in May 2010. OMB's "Updated Guidance on the American Recovery and Reinvestment Act" memo issued on March 22, 2010, addressed the importance of corrective actions and timely audit resolutions, and noted that agencies should not grant any requests to extend the Single Audit Act reporting deadline for fiscal years 2009 through 2011.[8]

We view OMB's collective actions as a positive step toward focusing the Single Audit on Recovery Act programs that may be smaller but carry higher risks. In the longer-term, we believe there is opportunity to further enhance the risk assessment process, which drives the determination of which programs are audited. As directed by OMB Circular No. A-133, the current risk assessment process and resulting scope of audit

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[8]The Single Audit Act requires that recipients submit their financial reporting packages, including the Single Audit report, to the clearinghouse designated by OMB within the earlier of 30 days after receipt of the auditor's report or 9 months after the end of the period being audited.

work are largely driven by the amount of federal expenditures in a program during a fiscal year and whether findings were reported in the previous period. OMB currently has several initiatives looking at issues relating to the Single Audit process. We will continue to monitor OMB's actions in this area.

- **How well prepared are auditors to evaluate ARRA programs as they conduct Single Audits? Should the federal government offer more outreach and assistance to auditors?**

To help auditors prepare to conduct single audits, we believe that it is vital that OMB provide timely and clear guidance related to auditing federal awards through the single audits. Timely guidance would also better enable federal agencies to provide outreach and assistance to auditors.

In August 2009, OMB issued Circular No. A-133 Compliance Supplement Addendum I which provided both new and updated information related to Recovery Act programs. However, many questions arose from this guidance. In September 2009, OMB provided clarifying guidance to the audit community through the American Institute of Certified Public Accountants, Governmental Audit Quality Center. This guidance applied to 2009 audits. As many states have a June 30 year-end, this guidance was provided late as many audits were already underway. As stated above, OMB plans to issue Recovery Act related guidance for 2010 in May 2010.

Question Five: GAO reported that the federal government's inability to provide assurance that it had properly reported its property, plant, equipment and inventories—primarily held by the Department of Defense or DOD, was a factor in the government's receiving a disclaimer on its accrual-based consolidated financial statements.

- **What steps must DOD take to resolve this issue?**

The Department of Defense (DOD) needs to design and implement improvements to financial management systems, processes and controls that would help to ensure the accurate accounting for and reporting of property, plant, and equipment in conformity with generally accepted accounting principles.

Because of DOD's size, complexity, and the uniqueness of its assets, accurate accounting for and reporting on property, plant, and equipment is a considerable undertaking, one that may be most effectively approached through both a short-term and long-term approach.

Over the past year, DOD's Office of Under Secretary of Defense (Comptroller) (OUSD(C)) has focused resources on the following two short-term priorities:

- Strengthening budgetary information and processes and achieving an auditable Statement of Budgetary Resources.

- Accounting for mission-critical assets, a subset of DOD's property, plant, and equipment, and inventory. The OUSD(C) is further narrowing its focus to verification of the existence and completeness of mission-critical assets, which involves capturing and recording the number of each type of weapon system, real property, inventory, and operating materials and supplies.

Emphasis on asset valuation and other balance-sheet items is planned to increase as the above priority areas prove auditable.

We are supportive of this initiative and believe that a focused and consistent approach may increase DOD's ability to demonstrate incremental progress toward achieving auditability in the short-term. Important to the success of this initiative are high quality plans and effective implementation at all levels.

Long-term, to achieve auditability and improve financial management information, DOD will need a sound strategic plan that is implemented effectively throughout the department with efforts that can be sustained through transitions of leadership between administrations.

DOD's long-term planning is laid out and reported through the Financial Improvement and Audit Readiness (FIAR) Plan and periodic updates. Fundamentally important steps to improve this plan's chances for success are laid out in our May 2009 report.[9] Our recommendations include the following:

- issue guidance to standardize the development of the components' Financial Improvement Plans (FIP) that support the FIAR Plan;
- establish a baseline of financial management capabilities and weaknesses;
- establish metrics for progress toward financial management capabilities, addressing weaknesses, and achieving goals by milestone dates; and
- assign accountability for achieving results to specific offices or organizations.

DOD has taken steps, consistent with our recommendations, to (1) standardize component-level FIPs and (2) identify and address gaps in corrective actions planned at the component level and improve progress reporting. However, this will be a long-term effort and its effects on the FIAR Plan will be gradual. Another long-term challenge will be the successful deployment of Enterprise Resource Planning (ERP) systems. DOD has stated that the new systems, and the related changes to processes and controls concurrently taking place, set the critical path for eliminating many of the root causes that make DOD financial management a high-risk area. However, we have reported our concerns on the DOD ERP implementation efforts.

Question Six: Given DOD's size and the scope of its operations, the resolution of its serious financial management problems is crucial to the improvement of financial management across the government, and ultimately to achieving a clean audit

[9] GAO, *Financial Management: Achieving Financial Statement Auditability in the Department of Defense*, GAO-09-373 (Washington, D.C.: May 6, 2009).

opinion. Yet, DOD continues to deal with decades-old financial management and business problems related to its systems, processes (including internal controls), and human resources. Among the 30 areas on GAO's government-wide "high-risk" list, 8 are listed as DOD program areas, and the department also shares responsibility for 7 other issues. These problems prevent DOD from producing accurate, reliable, and timely information with which to make sound decisions and report on its operations.

- **What major challenges in financial management does DOD face?**

- **If DOD is able to achieve a clean audit opinion on its financial statement, will this accomplishment justify removing DOD's financial management from GAO's high risk list?**

DOD faces major challenges in accounting for its funds and assets. DOD's financial management and related systems do not adequately support material amounts on the financial statements, and long-standing material weaknesses over financial reporting continue to exist. Additional challenges for DOD's financial management include the size and complexity of the organization, thousands of isolated automated information systems accumulated over time, a critical mission that understandably overshadows important support operations, and changes in personnel and leadership that make initiatives difficult to sustain over time and across administrations.

Achieving a clean audit opinion for DOD will take a long-term effort. A clean audit opinion is an indicator of effective financial management only if producing auditable financial statements can be sustained as part of the organization's normal financial operations. For the short term, we believe the OUSD(C)'s focus on two priorities—improving budgetary information (including the Statement of Budgetary Resources) and asset accountability—may strengthen DOD's ability to show incremental progress toward auditability. Once the priority areas have proved auditable, emphasis is planned to shift toward the greater challenge of asset valuation and other balance-sheet items.

Audit readiness is only part of the larger challenge DOD faces in moving from high-risk to sound financial management. In addition to auditable financial statements, DOD's financial management systems, processes, and personnel must be capable of producing reliable, useful, and timely financial information that managers can use for more effective decision making.

Key indicators of progress will be the steps military components take to reach meaningful milestones laid out in their plans to support the FIAR Plan, and the steps they take in response to recommendations for more effective strategic planning and integration of their ERP systems to support DOD financial management.

Another element essential to reducing risk and sustaining improvements to financial operations and systems is having the right financial management workforce and retaining people with the right financial management education, skills, and experience.

We have been encouraged by DOD's current priorities, which could, with effective and sustained follow-through, set a path toward DOD financial management's removal from the high-risk list. However, the department needs to achieve significant, sustained progress in systems and controls beyond obtaining a clean opinion on its financial statements to warrant removal of this area from the high-risk list.

Responses to Ranking Member Issa's Questions for the Record

Question One: Many agencies still do not have effective financial management systems in place that can produce useful and relevant information with which to make informed decisions on an ongoing basis. While the number of unqualified or "clean" audit opinions on agencies' financial statements has risen to 20 out of the 24 CFO Act agencies for FY 2009, auditors reported that the financial systems in 10 out of those same 24 agencies lacked substantial compliance with at least one of the Federal Financial Management Improvement Act's (FFMIA) three requirements – which are that financial systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the Federal government's Standard General Ledger at the transaction level.

- **Please address the impact that new financial management technologies could have on the ability of agencies to improve their financial systems. What are the consequences of not having a modernized, integrated financial management system? What are the key challenges agencies face in modernizing their systems?**

New financial management system technologies offer many opportunities to improve agencies' financial systems. Our work[10] has shown, however, that effective implementation of new financial management systems has been a significant challenge for federal agencies, and related critical factors to consider include developing transition plans, reengineering business processes, and limiting customization of commercial-off-the-shelf systems. In the *2009 Financial Report of the United States Government*, Treasury reported that OMB plans to issue new guidelines and strategies for approaching financial system modernizations that according to OMB officials, favor shorter-term, lower-cost, and easier-to-manage solutions in place of expensive and long-term investments in technology solutions. On March 30, 2010, OMB reported that the Office of Financial Innovation and Transformation—a new office within Treasury's Fiscal Service—in coordination with the CFO Council, will identify and facilitate the acquisition or development of initial operating capabilities for automated solutions for transaction processing as well as financial report production that would greatly reduce duplicate work at individual agencies.[11] However, there is much uncertainty with this new approach, and

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[10]GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, GAO-06-184 (Washington, D.C.: Mar. 15, 2006).
[11]OMB, Memorandum, *The Office of Financial Innovation and Transformation* (Washington, D.C.: Mar. 30, 2010).

participation would be voluntary. In addition, it is unclear how the systems and functions under the new approach will work with existing financial systems and solutions that provide these capabilities. Until a clearly defined approach and strategy is developed, it is unclear how these initiatives will impact the ability of agencies to improve their financial systems.

The consequences for agencies that do not have modernized, integrated financial management systems that substantially comply with the three FFMIA requirements are that they typically expend major effort and resources to periodically develop financial statement information that their systems should be able to provide on a recurring basis. Some federal agencies have been able to obtain unqualified audit opinions that according to their auditors, were the result of extensive labor-intensive efforts, which include using ad hoc procedures, hiring external consultants, expending significant resources, and making billions of dollars in adjustments to derive financial statements. For example, the Department of Health and Human Services' auditors reported that the department had to manually enter thousands of journal vouchers in excess of $259 billion in absolute value in its general ledger and used an error-prone spreadsheet process to manually enter financial data used to compile the department's consolidated financial statements. According to the auditors, these reported deficiencies were due to the lack of an integrated financial management system.

We have reported over a number of years that modernizing federal financial management systems has been a challenge at many federal agencies.[12] In March 2006, we identified several key causes of financial management system implementation failures within three recurring themes related to agencies not following best practices in (1) systems development and implementation efforts (commonly referred to as disciplined processes), (2) human capital management, and (3) other information technology management practices.[13]

Question Two: GAO has long called for DOD to have a high-level Chief Management Officer (CMO), serving a fixed term (5-7 years), to serve as the strategic, enterprise-wide integrator of DOD's overall efforts to transform its business operations. The National Defense Authorization Act of 2008 designated the Deputy Secretary of Defense as the CMO, while also establishing a new position of Deputy CMO.

- **Do you believe that adding the duties of the CMO to those already existing for the Deputy Secretary of Defense, as the 2008 Defense Authorization Act did, is sufficient, or does GAO still favor a separate CMO position?**

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[12]See, for example, GAO-06-184; GAO, *Financial Management: Persistent Financial Management Systems Issues Remain for Many CFO Act Agencies*, GAO-08-1018 (Washington, D.C.: Sept. 30, 2008); and *Financial Management Systems: OMB's Financial Management Line of Business Initiative Continues but Future Success Remains Uncertain*, GAO-09-328 (Washington, D.C.: May 7, 2009).
[13]GAO-06-184.

Because of the complexity and long-term nature of DOD's business transformation efforts, GAO has reported the need for a separate Chief Management Officer (CMO) position with significant authority, experience, and a sufficient term to provide focused and sustained leadership. To its credit, DOD's senior leadership has shown a commitment to transforming business operations and taken steps to strengthen its management approach. In May 2007, the Secretary of Defense designated the Deputy Secretary of Defense as DOD's CMO. The National Defense Authorization Act for Fiscal Year 2008 codified the CMO position, created a Deputy CMO (DCMO) position, directed that CMO duties be assigned to the under secretary of each military department, and required DOD to develop a strategic management plan for business operations. In 2008, DOD issued its first plan and directives that outlined broad CMO and DCMO roles and responsibilities, established a DCMO office, and named an Assistant DCMO. In July 2009, DOD updated its strategic plan. Prior to these actions, DOD had established various governance entities, such as the Defense Business Systems Management Committee, which is intended to serve as the primary transformation leadership and oversight mechanism, and the Business Transformation Agency to support the committee.

While GAO recognizes that DOD has taken several positive steps, it still lacks critical elements needed to ensure successful and sustainable transformation efforts. Specifically, DOD needs to more clearly establish the roles and responsibilities, as well as relationships, among various business-related positions and governance entities. As currently defined, the DCMO position appears to be advisory. Specifically, the DCMO assists the CMO, but the position has not been assigned clear decision-making authority or accountability for results. DOD also has yet to clearly define the relationship between the DCMO and military department CMOs or the unique and shared responsibilities of various governance entities, such as identifying how they would manage and integrate transformation efforts. Finally, DOD needs to take additional actions to further develop a viable business transformation plan, supported by a strategic planning process that includes specific goals, measures, and accountability mechanisms to measure progress.

As DOD continues to develop and implement its approach, GAO remains open to the possibility of further progress. However, because of the roles and responsibilities currently assigned to key positions, it is still unclear that DOD will be able to provide the long-term sustained leadership needed to address significant challenges in its business operations. Depending on the outcome of DOD's approach, GAO continues to believe that modifying existing legislation to establish the CMO position as a separate, full-time position with sufficient authority and an appropriate term to sustain progress across administrations remains a viable alternative.

Question Three: For the third year in a row, GAO offered an unqualified opinion on the U.S. Government's Statement of Social Insurance (SOSI), which includes Medicare and Social Security. However, as pointed out in a recent press account, "[w]hile the book-keeping for the Statement of Social Insurance might be reliable, it's hardly good news. The data show that the present value of projected scheduled benefits exceeds earmarked revenues for Social Security and Medicare by about $46 trillion during the next 75 years."

- **Please provide an explanation of any uncertainties regarding the accuracy of SOSI projections, despite its being awarded an unqualified opinion.**

Because long-term projections and estimates involve a range of assumptions and factors, careful consideration is given by both the preparer and auditor of the financial statements regarding disclosures of uncertainties related to the projections and estimates. Accordingly, in our audit report, we noted various uncertainties regarding the SOSI projections. These consist of inherent uncertainties associated with (1) the lengthy projection periods that are used, and (2) the use of reasonable assumptions that are nonetheless affected by the likelihood of future changes in general economic, regulatory, and market conditions as well as other more specific future events, significant uncertainties, and contingencies. Supplementary Medical Insurance (SMI) Part D projections have an added uncertainty in that they were prepared using very little program experience upon which to base the estimates, and the SMI Part B projections assume significant reductions in physician payments, as required under current law, which may or may not occur. In addition, scheduled future benefits reported in the SOSI are based on benefit formulas in current law, but the Social Security and Medicare programs are not sustainable under current financing arrangements and the law concerning these programs can be changed at any time by the Congress. Disclosure of uncertainties alerts the reader that, because of the uncertainties, actual revenues and expenditures for the SOSI programs (e.g., Social Security and Medicare) could materially differ from the projected amounts in the SOSI. Additional details regarding these uncertainties can be found on pages 215 and 216 of the *2009 Financial Report of the United States Government.*

Question Four: GAO continues to place the Defense Department's Financial Management and Business Systems Modernization programs on its 2009 "high risk" list even though those same areas were designated as "high risk" 15 years ago in 1995.

- **Why has so little progress been made in 15 years that Defense financial management is still a high risk area, and do you see any hope for meaningful improvement in the short term?**

DOD is one of the largest and most complex organizations in the world. DOD's operations span a wide range of organizations, including the military services and their respective major commands and functional activities, many agencies and field activities, and combatant and joint operational commands responsible for military operations. To support its operations, the department accounts for and manages billions of dollars in performing its varied business functions—including several on the GAO's high-risk list, such as weapons systems acquisition, supply chain management, and contract management—using thousands of automated business systems, many of them isolated legacy systems.

The magnitude and complexity of DOD's financial management and related business transformation challenges underscore the need for focused and sustained leadership to guide the department's efforts to address weaknesses in financial management and other high-risk areas. Overhauling the department's financial and related business operations could take many years to accomplish and represents significant management challenge.

Despite DOD's daunting long-term challenges, we do see hope for meaningful improvement in the short-term that can lead to long-term improvement. OUSD(C) has set short-term priorities for financial improvement that focus on strengthening budgetary information and processes and achieving an auditable Statement of Budgetary Resources, and accounting for mission-critical assets. Budgetary information is given first priority because of its importance to DOD managers in making decisions based on reliable, useful, and timely financial information and because it will also contribute to achieving a clean audit opinion.

The secondary emphasis is on mission-critical assets. OUSD(C) has focused on verifying the existence and completeness of these assets, which captures the number of each type of weapon system, real property, inventory, and operating materials and supplies.

DOD and each of the military services have long-term efforts underway to modernize their business systems, including efforts to develop business enterprise architectures and to define and develop system modernizations to address specific weaknesses in business operations (e.g., logistics, personnel management, and financial management). The successful implementation of these business systems, including their interoperability across DOD components, is critical to the department's success in addressing some of its high-risk areas, such as financial management, supply chain management, and overall transformation of the department's day-to-day business operations. Further, DOD's successful implementation of these business systems would enhance the department's ability to achieve auditability. We plan to soon issue an updated report on DOD business system modernization.

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If you or your staff have questions concerning the responses above, please contact me at (202) 512-5500 or Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-3406 or engelg@gao.gov.

Gene L. Dodaro
Acting Comptroller General
of the United States

(198623)

Ms. WATSON. Thank you so much, Mr. Dodaro.
Now we will proceed with Mr. Gregg.

STATEMENT OF RICHARD GREGG

Mr. GREGG. Chairwoman Watson and Congressman Schock, thank you for inviting me to discuss the financial report of the U.S. Government for fiscal year 2009 and the related audit by the Government Accountability Office. Your interest in improving financial management is greatly appreciated.

The financial report is prepared from the audited financial statements of specifically designated Federal agencies, including Cabinet departments and many smaller independent agencies. In fiscal year 2009, 20 of the 24 CFO Act agencies earned unqualified opinions on their financial audits. It is particularly noteworthy that the Department of Treasury, itself, received a clean audit this year. Given the number and the complexity of the new programs that deal with the economic crisis, the clean opinion reflects exceptional work by Treasury and its auditor, GAO.

The U.S. Government also achieved a third consecutive unqualified or clean audit on the statement of social insurance; however, for fiscal year 2009 GAO was again unable to express an opinion on the other Government-wide financial statements. The disclaimer on those statements stems from three longstanding material weaknesses: serious financial management and control issues at the Department of Defense, the inability to adequately reconcile and account for intergovernmental activities and balances between agencies, and deficiencies in the process of preparing the consolidated financial statements.

We nevertheless have made progress over the years in resolving many GAO findings. Treasury and OMB's efforts to date have resulted in the reduction of GAO findings and recommendations by more than two-thirds, from more than 150 a few years ago to just over 40 in fiscal year 2008.

But we have been less successful in fixing some basic structural problems. GAO, for example, has repeatedly identified our inability to balance the intergovernmental transactions between Government agencies, and, while it will take all agencies working together to eliminate this as a material weakness, Treasury, working with OMB, will assume responsibility for fixing it.

The process for preparing consolidated financial statements is also a material weakness. This material weakness includes numerous shortfalls, but, most importantly, there is a structural deficiency whereby key accounting components had not been included in our consolidation process. Treasury has developed an accounting structure to resolve this issue. This new structure will need to be tested and implemented, but within a couple years we should be able to make significant improvements in the financial report preparation process.

The Government's mainly accrual based net operating cost for fiscal year 2009 increased nearly $250 billion from a year earlier to $1.25 trillion. This increase results primarily from the substantial decline of more than $460 in Government revenues, due in large part to the effects of the recession and tax changes associated with the stimulus package. The Government's budget deficit for 2009 was $1.4 trillion.

The Government's balance sheet shows that its liabilities exceed its assets by more than $11 trillion, and the largest categories of liabilities are the Government's debt held by the public, $7½ trillion, and the Federal employees' and veterans' post-employment liabilities are more than $5 trillion.

For fiscal year 2009 the Government's balance sheet reflects that many investments have been made pursuant to the economic recovery shortfalls. These include $240 billion in outstanding TARP investments, as well as investments in Fannie Mae and Freddie Mac, two preferred stock purchase agreements valued at $65 billion, and $185 billion of mortgage backed securities.

It is important to note that the financial report also discloses significant activity that occurred after fiscal year 2009, including an additional $90 billion repaid from TARP recipients and a modifying of funding commitment cap for Fannie and Freddie.

Although market stabilization and economic recovery were the priority for fiscal year 2009, the continued issue of fiscal sustainability is not being overlooked. The report discusses the Government's long-term fiscal challenges of funding Social Security, Medicare, and Medicaid programs, programs which will account for a large and growing portion of total Government spending in both the near term and the long term.

An important message conveyed in this year's financial report is that the longer that action to resolve these shortfalls is delayed, the greater the challenge will be to bring these important programs into fiscal balance.

For the third year, Treasury, with support from OMB and GAO, has issued a companion document, the Citizen's Guide for the Financial Report, which is an abbreviated form of the longer financial report and is a much easier read for the American citizens.

Finally, in closing, I do appreciate the work that the committee has done. The efforts on pulling together the financial report is a challenging one, with very large Government agencies trying to compile hundreds of thousands of documents and information in a very short period of time and get it right.

I think we have made progress. We still have a long way to go, and I certainly recognize that.

Thank you, Chairwoman Watson. I look forward to your questions.

[The prepared statement of Mr. Gregg follows:]

Embargoed Until 10:00 a.m. EDT, April 14, 2010

Treasury Fiscal Assistant Secretary (Acting) Richard Gregg
Written Testimony
House Committee on Oversight and Government Reform
April 14, 2010

Chairwoman Watson, thank you for inviting me to the Committee's hearing to discuss the Financial Report of the United States Government (Financial Report) for Fiscal Year (FY) 2009 and the related audit by the Government Accountability Office (GAO). Your interest in improving Federal financial management is greatly appreciated.

Audit Results

The Financial Report is prepared from the audited financial statements of specifically designated Federal agencies, including Cabinet departments and many, smaller, independent agencies. In FY 2009, 20 of the 24 CFO Act agencies[1] earned unqualified opinions on their financial statement audits. It is particularly noteworthy that the Department of the Treasury itself received a clean audit this year. Given the number and complexity of the new programs that deal with the economic crisis, the clean opinion reflects exceptional work by Treasury and its auditor, GAO.

The U.S. Government also achieved a third consecutive unqualified or 'clean' audit opinion on the Statement of Social Insurance. However, for Fiscal Year 2009, GAO was again unable to express an opinion on the other governmentwide financial statements. The disclaimer on those statements stems from three long-standing material weaknesses: serious financial management control issues at the Department of Defense; the inability to adequately account for and reconcile intragovernmental activity and balances between agencies; and deficiencies in the process for preparing the consolidated financial statements.

We nevertheless have made progress in resolving many GAO findings over the years. Treasury and OMB's efforts to date have resulted in the reduction of GAO findings and recommendations by more than two-thirds - from more than 150 a few years ago to just over 40 for the FY 2008 audit.

A New Approach is Needed

But we have been less successful in fixing some basic structural problems. GAO, for example, has repeatedly identified our inability to balance the intragovernmental transactions between government agencies. While it will take all agencies working together to eliminate this material weakness, Treasury, working with OMB, will assume responsibility for fixing it.

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[1] The Department of Defense, Homeland Security, NASA, and the Department of State did not receive unqualified opinions.

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The process for preparing the consolidated financial statements is also a material weakness. This material weakness includes numerous shortfalls, but most importantly there is a structural deficiency whereby key accounting components have not been included in our consolidation process. Treasury is developing an accounting structure to resolve this issue. This new structure will need to be tested and implemented, but within a couple of years we should be able to make significant improvements in the Financial Report preparation process.

Finally, Treasury, in concert with OMB and other agencies, will be identifying opportunities to use common systems to perform accounting and transaction processing. This will be coupled with a renewed energy to move away from paper processing and payments, to electronic processes. With more shared systems and more automated processes, costs will be reduced and the quality and timeliness of information will be improved.

Financial Highlights and Recovery Activities

The Government's mainly accrual-based net operating cost for FY 2009 increased nearly $250 billion from a year earlier, to $1.25 trillion. This increase resulted primarily from a substantial decline of more than $460 billion in government revenues due in large part to the effects of the recession and the tax changes associated with the 2009 stimulus package. The Government's budget deficit for FY 2009 was $1.4 trillion.

The Government's balance sheet shows that its liabilities exceed its assets by more than $11 trillion dollars. The largest categories of liabilities are the Government's debt held by the public ($7.6 trillion) and federal employee and veterans postemployment benefit liabilities of more than $5 trillion.

For Fiscal Year 2009, the Government's balance sheet reflects the many investments that have been made pursuant to the economic recovery efforts. These include $240 billion in outstanding Troubled Asset Relief Program (TARP) investments, as well as investments to Fannie Mae and Freddie Mac through preferred stock purchase agreements valued at $65 billion and $185 billion of mortgage-backed securities (MBS). It is important to note that the Financial Report also discloses significant activity that occurred after the end of FY 2009, including an additional $90 billion repaid from TARP recipients and the modifying of the funding commitment cap for Fannie and Freddie.

Fiscal Sustainability

Although market stabilization and economic recovery were the priority during FY 2009, the continuing issue of fiscal sustainability is not being overlooked. The report discusses the Government's long-term fiscal challenges of funding the Social Security, Medicare, and Medicaid programs -- programs which will account for a large and growing portion of total government spending in both the near term and long term. An important message conveyed in

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this year's Financial Report is that the longer that action to resolve these shortfalls is delayed, the greater the challenge will be to bring these important programs into fiscal balance.

Citizen's Guide

A common critique of the Financial Report of the U.S. Government is that, since it contains more than 200 pages of detailed information on the Government's financial position and condition, it is not a practical document for communicating with the American citizen. In response, the Treasury Department and OMB, in cooperation with GAO, developed and issued a summary report entitled, *The Government's Financial Health—A Citizen's Guide to the Financial Report of the U.S. Government* for the third year in a row. This Guide provides a summary of the key data and issues addressed in the full report in a more "user-friendly" manner to the general public.

Conclusion

The process of producing the Financial Report of the U.S. Government and annual agency financial reports can have a significant impact on ensuring effective management and control of the Government's finances. The improvements in financial systems and business processes that many agencies have made as a result of audited financial statements has led to better underlying financial data. However, the process of preparing the Financial Report is a complex one, with many needs and opportunities for improvement. Treasury looks forward to working with OMB, GAO, and the many Federal agencies involved to improve the process, and consequently, the Report itself.

Thank you, Chairwoman Watson. This concludes my testimony. I look forward to your questions.

Acting Fiscal Assistant Secretary Gregg's responses to Chairwoman Watson's Questions for the Record

Hearing on Federal Financial Management House Oversight and Government Reform Committee

April 14, 2010

1. U.S. government agencies, departments, or other components that do business with each other are called trading partners, and intragovernmental transactions take place between trading partners. For years, GAO has reported that federal agencies are unable to adequately account for and reconcile their intragovernmental activity and balances.

    - What major progress has been made in this area?

    Treasury is continuing to work with Federal agencies to reconcile intragovernmental activity and reduce the balancing adjustment in the Statement of Operations and Changes in Net Position. This is a governmentwide issue that is not specific to one agency.

    Major progress has been made in the area of fiduciary intragovernmental differences. Fiduciary accounts include investment and interest between the Bureau of Public Debt and other federal agencies, as well as borrowing and interest between Treasury's Federal Financing Bank and other federal agencies. Treasury has placed focused effort on these differences for the last three years, reducing the differences by over 50 percent. Similar efforts are being planned for other types of intragovernmental differences.

    - What does Treasury consider to be obstacles that prevent federal agencies from appropriate reconciling intragovernmental activity and balances?

    The lack of a single accounting system used by all agencies with internal forced balancing mechanisms is probably the largest obstacle preventing federal agencies from appropriately reconciling intragovernmental activity and balances. Unfortunately, the cost of a single system for the entire federal government precludes such a possibility.

    The next largest obstacle is the lack of a separately reported General Fund, which is the accounting for central government funds and transactions. This results in an accounting framework that is incomplete, which creates the bulk of the intragovernmental differences. This is also the major contributing factor to the audit finding on report consolidation.
    There is also a need to ensure that agencies account for transactions using the U.S. Standard General Ledger. Treasury is developing processes, discussed

below, to help agencies reconcile their information not only with other agencies' information, but also with the main Treasury accounting system.

- Does Treasury have both short and long-term strategies in places to address these obstacles?

In the short term, Treasury has created and led workgroups aimed at researching, analyzing, and resolving longstanding intragovernmental imbalances, and it will be expanding these efforts. Treasury is also developing ways to more easily distribute authoritative information contained in its main accounting system (e.g., appropriations, transfers) to agencies to facilitate the reconciliation process for these specific intra-governmental transactions. Treasury provides assistance and various information reports to the agencies to help them resolve differences. On a quarterly basis, Treasury provides material difference reports that identify each agency's difference by trading partner and by transaction type.

Treasury is also taking steps to resolve the lack of separately reported General Fund, which is the accounting for central government funds and transactions. Treasury is creating a process that will further define the structure and reporting of the flow of funds from the central government to and from the agencies. This is a major undertaking, but a necessary one to resolve the audit finding not only on the intragovernmental diffferences, but also on the consolidation of the governmentwide financial statements. We are targeting FY 2012 for the audit and inclusion of the General Fund in the consolidation process.

Finally, Treasury is developing a system (Financial Information Report Standardization) that will ensure that the data in agencies' accounting records is consistent with the financial data they report to Treasury, and that agency accounting complies with the U.S. Standard General Ledger's accounting logic. That system is expected to be available by FY 2013.

2. Over time, GAO has cited the accounting and reconciling of intragovernmental transactions as a material weakness in the U.S. Government's financial reports which has contributed to a disclaimer of opinion.

    - Please describe what actions Treasury and other relevant agencies are taking to overcome this issue.

Of the actions described above, the most significant one necessary for overcoming this issue is the work on the General Fund. Currently, agencies' transactions with the General Fund are not eliminated in consolidation because the current structure of the General Fund does not in all instances provide an account or accounts to post an eliminating entry. Creating and reporting a General Fund will resolve the largest source of intragovernmental differences.

We are continuing other efforts to provide agencies with information from the main Treasury accounting system to reconcile to, similar to bank confirmations in the private sector. In addition, as mentioned above, Treasury will expand its efforts to work with agencies to resolve the longstanding existing intragovernmental differences. Going forward, our new Office of Financial Innovation and Transformation will be involved with centralizing and streamlining interagency processes and systems, and that should improve the accounting process between agencies.

- When do you anticipate that these material weaknesses will be resolved and no longer referred to in GAO's audits of federal financial reports?

We believe that developing and implementing a structure that properly accounts for central government funds and transactions (General Fund), in concert with our other efforts, will lead to the resolution of the material weakness related to the intragovernmental transactions during the audit of the FY 2012 financial statements.

3. In addition to the material weaknesses cited, GAO's audit report on the FY 2009 consolidated financial statements pointed out major deficiencies in internal control, including (1) loans receivable, mortgage-backed securities and loan guarantee liabilities; (2) verification procedures for data input for the TARP equity investment and direct loan valuations.

   - Tell us how Treasury intends to eliminate these deficiencies, and what is the timeframe for doing so?

There was an audit finding on the lack of adequate documentation for unique Federal Credit Reform Act (FCRA) transactions for the purchase and disposition of mortgage-backed securities under the authority provided in the Housing and Economic Recovery Act of 2008. FCRA has significant documentation requirements to support accurate accounting and financial reporting. As the mortgage-backed securities program started late in fiscal year 2008 and was very intense in fiscal year 2009, maintaining adequate FCRA documentation lagged somewhat behind the transactions for a time. However, as the year progressed, the Treasury Department worked hard - and successfully – to implement the FCRA documentation requirements, so that the requirements were in place before the end of fiscal 2009. We are continuing to keep the documentation up to date in FY 2010.

Regarding the verification procedures for data input for TARP investment and loan valuations, manual inputs within the credit reform accounting models have been replaced with inputs referencing values in a relational database. These values are reviewed and validated against source documents and appropriate controls have been established. Thus, this 2009 deficiency has likewise been corrected.

4. On April 5, 2010, Treasury and OMB announced the creation of a new office to improve financial management across the government. The Office of Financial Innovation and Transformation, or FIT, will be located within Treasury.

   - Please tell us about some of the issues you expect to be part of the agenda of this new office.

   In recent years, Chief Financial Officers have assumed new responsibilities for emerging priorities such as strengthening internal controls over financial reporting and reporting financial information beyond traditional financial statements. However, technology adoption has not been able to keep pace with these added responsibilities due to obsolete technologies or inadequate implementation and execution of new technology.

   To close this technology gap, the Office of Financial Innovation and Transformation (OFIT) will focus on efforts to support the development of government-wide financial solutions associated with agency financial management services (e.g., invoice processing, interagency agreement management). This Office will be tasked with developing options for streamlining the processing of financial information.

   These new automated solutions will be web-based; allow agencies to share common data, require little to no duplicate data entry; have complete financial information; and, as appropriate, provide the public access to financial information. The solutions will reduce cost and improve the data quality and usefulness of our financial data.

   - What will be involved in "charting a new course for financial management"?

   OFIT will identify and facilitate the acquisition or development of initial operating capabilities (IOC) for central automated solutions for transaction capture and processing as well as financial reporting that would greatly reduce duplicate work at individual agencies. OFIT will then use pilot efforts to phase in these solutions across the federal government, based on the agencies' needs. The objective is to more closely align financial systems under a coordinated governmentwide financial system architecture.

   Currently, OFIT is moving ahead with three IOCs for the following:

   - A shared solution for electronic capture of vendor invoice data;

- A financial repository of Treasury data that will initially capture invoice and payment information for contract goods and services and later expand to other Treasury financial information, as appropriate; and
- A design for a shared solution to develop, capture, and report all interagency buy-sell activity.

The leveraging of a fully automated approach, like the electronic invoicing capability, will improve data quality through automation and will increase efficiency for agencies that use this service. OMB and the Treasury, in coordination with the CFO Council, will identify and facilitate the acquisition or development of automated solutions for transaction processing and the capture of financial transactions.

Ms. WATSON. Thank you so much, Mr. Gregg. I just want to refer all Members to the Federal Government's financial health. I think it would be very informative for all of us to read it thoroughly.

I would like now to proceed to Mr. Werfel. Will you continue, please.

STATEMENT OF DANNY WERFEL

Mr. WERFEL. Thank you, Chairwoman Watson, Congressman Schock, and other members of the subcommittee for the invitation today to discuss Federal financial management issues with you.

This November will mark the 20th anniversary of the Chief Financial Officers Act of 1990. This is an opportune time to reflect on Federal financial management community's progress during the last 20 years and plot a course for where and how the community will advance in the next 20 years.

Over these past 20 years, the Federal Government has built a solid foundation of strong accounting practice, including disciplined and consistent financial reporting, high functioning risk management frameworks that are driving internal control improvements in financial reporting, and integration between transaction processing and our accounting records. As a result, the number of clean audit opinions at Federal agencies has risen steadily over time, while auditor identified material weaknesses have declined.

This does not mean that our journey is complete. To the contrary, more work is necessary to strengthen this foundation, including addressing the ongoing weaknesses that prevent the Department of Defense, NASA, the Department of Homeland Security, the State Department, and the Government, as a whole, from achieving a clean audit opinion.

Perhaps even more critical, significant work remains in areas of financial management that tie more directly to the American public's bottom line: the elimination of Government waste in areas such as improper payments, unneeded Federal real estate, and cost overruns in the deployment of our new financial systems. Moreover, as the public demands increases for information on where taxpayer dollars are going and how they are being used, the Federal financial community must rise to this challenge and produce this information more timely and reliably.

Before I turn to these priorities, I would like to spend a few moments on the important impacts that the Federal economic recovery efforts are having on the Federal financial management community today.

First, I would like to commend the Treasury Department for the extraordinary accomplishment of achieving a clean opinion on the first ever audit of the financial statements for the Troubled Asset Relief Program [TARP]. The TARP program presents a unique financial reporting challenge, given the complex nature of the transactions and the volume of activity involved. For the Treasury Department to achieve a clean audit in the very first year of the program demonstrates how far the Federal Government has come in the sophistication and adeptness of our solutions for reporting traditional accrual based financial statements.

At the same time, the American Recovery and Reinvestment Act presented a different reporting challenge to the Federal financial management community, requiring more frequent and detailed information on Federal spending than has ever been traditionally captured by our financial statements. Due to system limitations and challenges of readily producing this information, many agencies have relied on herculean manual efforts to compile or combine information from several disparate systems to reply with the Recovery Act reporting requirements. In other words, we are commendably meeting the significant reporting challenge of the Recovery Act, but we need to reexamine our reporting infrastructure so that it better aligns to our efforts.

It is with this backdrop that OMB, working closely with the community, has established the following critical priorities moving forward. First, eliminating waste by reducing improper payments and/or investments in unneeded real estate. Second, closing the efficiency and technology gap in financial operations by ending an era of failed large-scale financial system modernizations in favor of shorter term targeted solution that reduces risk and cost by focusing only on our most critical business needs and aligning better to the capacity of our organizations to manage change.

And, third, promoting accountability and innovation through open government, by improving the reliability and completeness of Federal spend data, importantly including meeting the full mandate of the Federal Accounting and Transparency Act to capture sub-award data on USASPENDING.GOV, and by aligning the financial reporting model so that the information we report and audit is the most relevant to the public and agency decisionmakers, and that the internal controls that we scrutinize and prioritize resources to strengthen are more closely tied to the most significant financial risks we face.

My written testimony, along with the 2009 financial report, go into additional detail on each of these priorities.

I look forward to working with this subcommittee and other Members of Congress as we tackle these important issues.

Thank you again for inviting me to testify today. I look forward to answering your questions.

[The prepared statement of Mr. Werfel follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
www.whitehouse.gov/omb

Testimony of Daniel I. Werfel
Controller, Office of Management and Budget
before the
Subcommittee on Government Management, Organization, and Procurement
House Committee on Oversight and Government Reform
April 14, 2010

Thank you, Chairwoman Watson, Ranking Member Bilbray, and members of the Subcommittee, for the invitation to discuss Federal financial management issues with you today.

This year marks the 20th anniversary of the Chief Financial Officers (CFO) Act of 1990. This is an opportune time to reflect on the Federal financial management community's progress during the last 20 years and plot a course for where and how the community will advance during the next 20 years.

Much progress has been made since the passage of the CFO Act.

- Twenty of the 24 CFO Act agencies obtained unqualified[1] or "clean" audit opinions during fiscal year (FY) 2009, as compared to 18 of 24 unqualified opinions during FY 2001.

- We reported 38 auditor-identified material weaknesses during FY 2009, as compared to 64 material weaknesses in 2001.

- We have achieved a foundation of strong accounting practices, including: (1) disciplined and consistent financial reporting, (2) high-functioning risk-management frameworks that are driving internal control improvements in financial reporting, and (3) integration between transaction processing and accounting records.

This progress shows that Federal agencies devote significant time and resources to producing reliable, comprehensive financial statements for the United States taxpayers, legislators, and the financial management community itself.

While the financial management community has made significant progress, we continue to face challenges in meeting some of the basic standards for accounting and reporting. Several major agencies are still unable to produce auditable financial statements and we continue to face long-standing issues with the government-wide financial statements. Fiscal Year (FY) 2009 was also a challenging year for our nation's economy. With the passage of the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (Recovery Act) to help stimulate the economy and retain and create jobs, the Federal financial

[1] An unqualified or "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 or agency's financial position.

management community was responsible for implementing new programs, expanding existing ones, and still meeting OMB's rigorous deadlines for audited financial statements.

Response to the Federal Funding Accountability and Transparency Act, as amended (Transparency Act) and the Recovery Act, has demonstrated the public's interest in federal spending information that details where money is going and how it is being spent. Our current financial reporting model does not readily provide answers to these questions. The existing reporting infrastructure is not always nimble enough to meet these needs, necessitating untested and time consuming efforts to get necessary data. That is why the Administration has put forward aggressive financial management changes, including the appointment of a Senior Accountable Official for financial data quality at each agency and as released on April 7, 2010, a timetable for implementing the Transparency Act starting on October 1. By that date, agencies will be collecting data on sub-awards for all federal funds, and this data will be made available on USASpending.gov. While there is much to learn and more work to be done to fine tune the data collected at this detailed level, we are ready to take what we have learned this past year through the Recovery Act reporting and begin to meet the goals of the Transparency Act.

Going forward, and as we strive to meet the public's desire for this information, we need to re-examine our current reporting model to determine whether we are reporting and auditing the right information. This is one of the key areas the financial management community will explore this year.

Accomplishments

We have made great strides in advancing Financial Management. Twenty of the 24 CFO Act agencies achieved clean audit opinions as of FY 2009, covering more than 85 percent[2] of all Federal disbursements. In addition, the number of auditor-identified material weaknesses stands at 38, approximately a 40 percent decline from the 64 material weaknesses that were identified in FY 2001.

Of particular note, Treasury, in response to the financial markets crises this past year and the passage of EESA, established the Office of Financial Stability (OFS) to oversee the rescue efforts under the Troubled Asset Relief Program (TARP). Through OFS, the Treasury Department has helped achieve the broader goals of the Administration to restore stability to financial institutions, jump-start lending practices, and save families from losing their homes.

The Treasury Department and OFS accomplished a remarkable achievement by receiving clean opinions on their audited financial statements, considering the extraordinary challenges they faced and the varied and complex programs that were implemented. This accomplishment is a result of the Treasury Department and OFS' efforts to maintain the needed processes, disciplines, and controls over the funds entrusted to them. In addition, the Treasury consistently updates its website with information regarding TARP transactions to support the Administration's initiative to be more transparent on federal spending.

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[2] Based on the September 30, 2009 *Monthly Treasury Statement*

While Treasury has been successful at being more transparent for its TARP program, all agencies are being asked to be more transparent on its spending pursuant to the Transparency Act and Recovery Act. Reporting under the Transparency Act and Recovery Act is unlike any reporting the Federal financial management community has faced—the level of detail and the increased frequency of reporting is a significant shift from past practices. Agencies have aggressively worked towards achieving this unprecedented level of transparency—providing the public with better information about where and how money is being spent.

To better align with the increased transparency, this year the *Financial Report* included fiscal sustainability information on the Government's finances. The sustainability reporting in the *Financial Report* presents a long-term, comprehensive portrayal of projected spending and receipts for all programs.

In light of future fiscal challenges, as shown in the fiscal sustainability information presented in the *Financial Report*, it has never been more vital to provide better, more cost effective, and faster financial data.

Challenges

Although we have made advancements in financial management, it is incumbent upon the Federal community to build on this foundation of progress so that we are prepared to address the fiscal challenges that lie ahead. Federal managers must continue to mobilize resources and re-dedicate efforts to strengthen accounting practices, implement stronger internal controls, issue more timely financial reports, eliminate instances of error and waste, and use financial data to manage costs. We must approach these management improvement activities with an eye towards balancing the costs of our efforts against the benefits they ultimately derive for the taxpayer.

The financial management environment is changing from producing annual audited financial statements to producing financial reports more frequently, at a more granular level, and accompanied by non-financial information. This change is evident in the reporting required by the Transparency Act and the Recovery Act. This new paradigm has inspired the financial management community to re-examine our current infrastructure, and identify the systems and processes required to respond effectively to the changing environment.

While the financial management community has made significant progress over the years, in some areas we continue to face challenges in meeting some of the basic standards for accounting and reporting. While 20 of the 24 CFO Act agencies achieved clean audit opinions in FY 2009, several major agencies were unable to produce auditable financial statements. The Departments of Defense (DoD), Homeland Security (DHS), and State, and the National Aeronautics Space Administration (NASA) received disclaimers of an audit opinion. OMB and the Treasury Department will continue to work with these agencies to ensure that they have access to the tools that they need for proper reporting and that they instill the necessary processes and discipline to account for, and report, their financial transactions and position.

Not only do financial reporting challenges continue with these individual agencies, they continue at the government-wide financial reporting level with the *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[3] and the Statement of Social Insurance (SOSI)[4].

Fiscal Year 2009 was the 13th consecutive year the Federal government received a disclaimer of an audit opinion (no opinion) on its primarily accrual-based consolidated financial statements. The Federal government's Statement of Social Insurance (SOSI), however, received a clean audit opinion for the 3rd straight year. The SOSI is the first of the six principal financial statements to achieve this milestone.

The disclaimer of opinion on the *Financial Report's* five other principle financial statements is attributed to three government-wide material weaknesses;[5]

- The Defense Department's financial management challenges;
- The Government's inability to properly account for and reconcile the transactions it conducts among and between itself; and
- The preparation of the five statements themselves.

These material weaknesses remain a challenge at the government-wide level and must be overcome to provide the public at large with better information.

The state of Federal financial systems also plays a role in the challenges we continue to face as a community. Historically, agencies' efforts to modernize and implement financial systems have suffered problems, such as lack of a comprehensive project plan with a clear critical path, unclear governance structure and decision-making process, lack of buy-in from organizational leaders, and under-estimating the nature of the change management challenge that occurs in large and complex bureaucracies. These problems have resulted in system modernizations not meeting scheduled target dates and exceeding budgeted costs. Many of these challenges can be mitigated by adopting proven best practices, such as placing the right people with the right skill sets into positions as project managers, proceeding only with strong and wide-spread executive support, and aligning project scope to the most critical business needs of the agencies.

One functional area where existing financial systems have proven adequate is the production of annual financial statements. However, the agencies' financial systems are not sufficiently flexible or integrated with non-financial systems. This past year, agencies' systems were put to the test as the Recovery Act required both financial and non-financial data to be reported more frequently and at a much more granular level than previously required. Due to systems limitations and the challenges of readily producing this information, many agencies were forced

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

[4] 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.

[5] 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.

to rely upon herculean manual efforts to compile or combine information from several disparate systems to comply with the reporting requirements.

As a result, the financial management community needs to begin re-examining the expensive and long-term investments in technology solutions to support financial reporting and accounting and begin considering shorter-term, lower-cost, and easier-to-manage solutions that meet critical business needs, drive operational efficiency, and leverage shared service solutions. To this end, OMB and the Department of the Treasury are partnering to set a new course in financial management systems. In particular, OMB and Treasury, in coordination with the CFO Council, are working to deploy central, automated solutions that will reduce the cost and complexity of agency financial operations.

Path Forward

The financial management community has made great strides over the years. Recent experiences with the Transparency Act and the Recovery Act have helped to formulate a path forward for the Federal financial management community by leveraging the infrastructure we have built over the last two decades and focusing on three key areas—eliminating waste, closing the efficiency and technology gap in financial operations, and promoting accountability and innovation through open government.

Eliminating Waste

Our efforts to cut Government waste are focused on eliminating improper payments, better managing real property, and strengthening the audit framework for federally funded State and local activities. Based on information submitted by agencies in their FY 2009 Performance and Accountability Reports, the Government-wide error rate is 5 percent or roughly $100 billion, the highest amount reported to date. In response, in November 2009, the President issued *Executive Order No. 13520, Reducing Improper Payments*, to boost transparency of these errors, increase agency accountability through the designation of a Senate-confirmed official responsible for these errors, and create incentives for compliance for contractors and State and Local Government partners.

In addition, a Presidential memorandum, *Finding and Recapturing Improper Payments*, was subsequently issued, requiring agencies to use every tool available to identify and reclaim the funds associated with improper payments. We estimate we will recapture approximately $2 billion from the early phases of implementing this requirement. The Administration is also committed to improving the management of real property assets by creating incentives to dispose of unneeded Federal real property, including the incentive for all Federal agencies to retain net proceeds from the sale of excess property.

Lastly, OMB initiated a pilot project for an early review and reporting on the internal controls for major Recovery Act programs using the Single Audit process, as required under OMB Circular No. A-133, *Audits of States, Local Governments and Non-Profit Organizations*. This process, along with other efforts to strengthen the A-133, is intended to mitigate instances of waste in Federal grant programs.

Closing the Efficiency and Technology Gap in Financial Operations

Closing the efficiency and technology gap in financial operations will require the financial management community to examine our current investments in technology and explore alternate solutions that may be easier, quicker, and cheaper to implement. We need to modernize our financial systems within a reasonable time frame through better management to reduce schedule and cost overruns. Expensive and long-term investments in technology solutions to support financial reporting and accounting must be reconsidered in favor of shorter-term, lower cost, and easier to manage solutions that meet critical business needs, drive operational efficiency, and leverage shared service solutions.

To date, once deployed, our modern systems do not consistently meet our business needs or produce the right information to support decision-making. These projects incur significant cost overruns and delays, with the final result either of failed or sub-optimized deployments. The Administration is committed to closing the gap in public sector use of IT. As such, OMB will soon issue new guidelines and strategies for approaching financial system modernizations. The guidelines will focus on ensuring effective leadership over these projects; refocusing deliverables to tangible results within near-term timeframes; implementing relentless oversight that is publicly tracked through dashboards; and creating accountability within the agencies for these projects. We must change the way that we manage, procure, and implement financial systems within the Federal government.

In addition, new capabilities have emerged to automate and centrally implement financial management activities. For example, through a common electronic vendor invoicing solution, it is possible for vendors to input invoice data rather than agencies manually keying the information into a financial system. Leveraging a fully automated approach, the electronic invoicing capability will improve data quality through automation and increase efficiency for agencies that use this service. OMB and the Treasury, in coordination with the CFO Council, will identify and facilitate the acquisition or development of automated solutions for transaction processing and capture. The Office of Financial Innovation and Transformation (OFIT)—a new office within the Treasury Department—will work to identify and develop these innovations.

Promoting Accountability and Innovation through Open Government

In addition to providing annual audited financial statements, this Administration is committed to making federal expenditures of taxpayer dollars more transparent to the public by providing readily accessible, complete, accurate, and usable federal spending data. To realize this commitment, OMB issued M-10-06, *Open Government Directive*, to direct agencies to take action to support a more open government through transparency, participation, and collaboration. In addition, OMB most recently issued the memorandum, *Open Government Directive-Federal Spending Transparency*, on April 7, 2010, requiring agencies to begin collecting sub-award information after October 1, 2010, to improve the quality of information being reported now, and announcing enhanced capabilities for users of the USAspending.gov website. These additional efforts will expand the amount of information made publicly available, improve the data quality, and make it easier for the public to access this information.

The Federal financial management community has been fully engaged in making federal spending data more transparent. Full and easy access to information on government spending promotes accountability by allowing detailed tracking and analysis of the deployment of government resources. Transparency also gives the public confidence that we are properly managing its funds. Agencies have provided information more frequently and at a more detailed level through public websites such as USAspending.gov and Recovery.gov.

To further enhance transparency of financial information, we are also reviewing the reporting model and the underlying disciplines and processes historically used to produce annual financial reports to support the more rapid release and flexible presentation of financial information. We know agencies are obtaining clean audits, but it is time to question if we are auditing the right things. We are beginning to explore these issues to seek areas of improvement in meeting the needs of our stakeholders—the public, the Congress, and Federal executives.

A key factor to achieving a high level of performance in the financial community is focusing on obtaining cost information that reflects the cost of doing business. To this end, we are also considering measures that would strengthen reporting of cost information. In particular, we are exploring revisions to the Statement of Net Cost that would focus on the cost of doing business with cost accounting as the foundation of what is reported. Having a strong understanding of the cost of running the Federal Government will be a key tool for decision-makers as we face the sweeping challenges discussed today.

Conclusion

Looking at what we have achieved during the last 20 years and what we hope to achieve during the next 20 years is a self-reflection that is vital to the Federal financial community—particularly as we enter a new era of transparency and open government. We look forward to working with the Congress, GAO, and the CFO community to achieve our mutual goal of providing reliable and relevant financial information in a readily available and easily accessible format.

Thank you for inviting me to testify today. I look forward to answering your questions.

Ms. WATSON. Thank you.
We will proceed with Mr. Millette.

STATEMENT OF JAMES MILLETTE

Mr. MILLETTE. Chairwoman Watson, Mr. Schock, and other distinguished Members, I am pleased to have the opportunity today to testify on the State Department's 2009 financial statements. Our annual audit and agency financial report is the cornerstone of our efforts to disclose the Department's financial status and provide transparency and accountability to the U.S. people. We take this responsibility very seriously and take great pride in the improvements we have made in the Department's financial platform over the last decade.

The Department's financial activities are complex and set against a backdrop of global issues and engagements we face with nations around the world carrying out our foreign policy. They reflect the immense financial work that occurs behind scenes every day by the Department's financial officials operating at 260 locations around the world in over 172 different countries, operating with 150 different currencies, in often very dangerous places like Haiti, Afghanistan, and Iraq.

They also reflect our position as a shared financial service provider for over 40 customer agencies overseas, and we also have teamed with the Agency for National Development and run their financial system, as well.

We know that strong financial management and interest controls provide the building blocks to support the transparency of operations and accountability to effectively manage limited resources. We have worked diligently to embrace the broadening landscape of financial compliance and reporting requirements and proactively incorporate them into our ongoing budgetary and financial operations on a day-to-day basis.

We are proud that the Department has received clean audit opinions for eight out of the last 10 years. Last year's annual audit process was extremely difficult as we engaged a new audit firm to conduct our annual audit. Our experience told us that our worldwide operations and complexities carrying out our foreign policy was going to be difficult for a new firm to ascertain in the tight timeframes. Unfortunately, this proved so in the outcome, and we believe that the outcome of the audit doesn't really reflect the status of our finances.

Coming into the fiscal year 2009, the Department faced no previously identified material weakness in internal controls, and significant work had been done to address the 2008 significant deficiencies. In addition, I am pleased to report the Department maintains a robust system of internal controls overseen by the Department's senior leadership and administered by the Bureau of Resource Management.

For 2009 the Secretary was able to provide an overall unqualified statement of assurance about the Department's internal controls in accordance with the Federal Financial Manager's Integrity Act, as well as an unqualified statement of assurance for internal controls on financial reporting. However, the Department's new auditor issued an unqualified opinion for our consolidated statement of net costs and qualified opinions for our consolidated balance sheet and consolidated statement of net position.

The qualified opinions were based on the auditor's inability to satisfy themselves that property and equipment were free of material misstatements as of September 30, 2009. The new auditors were not able to satisfy themselves as to whether 2009 combined statement of budgetary resources was free of material misstatement in time to meet the deadlines, even though we were given a 30-day extension.

The new auditor identified three material weaknesses and three significant deficiencies that are the result of their work in 2009. The material weaknesses related to the need for the International boundary and Water Commission's liability statements refer to the accounting for our property and equipment and the timeliness of our fairness reporting. While we were extremely disappointed in the results, we are committed to addressing the items cited by the auditor and implementing corrective action plans to ensure we are in a better position this year as we move down the process.

I have included information in my statement on all these material weaknesses and would be happy to answer any questions.

[The prepared statement of Mr. Millette follows:]

Statement of
James L. Millette
Bureau of Resource Management
United States Department of State

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

"Oversight of Federal Financial Management"

2154 Rayburn House Office Building
April 14, 10:00

Good afternoon Chairman Watson, Ranking Member Bilbray, and distinguished Members of the Subcommittee.

I am pleased to have this opportunity to testify before the Subcommittee regarding the Department of State's FY 2009 Financial Statement. Our annual audit and Agency Financial Report (AFR) is the cornerstone of our efforts to disclose the Department's financial status and provide transparency and accountability to the American people. We take this responsibility very seriously and take great pride in improvements we have made in the Department's financial platform over the last decade.

The Department's financial activities are complex and set against the backdrop of the global issues and engagements we face as a Nation and institution working to carry out our foreign policy and advance U.S. interests abroad. They reflect the immense financial work that occurs behind the scenes every day by Department financial personnel as we operate in more than 260 locations, 172 countries, and in over 150 currencies, often in the most challenging environments. They also reflect our position as a shared financial services provider to more than 40 customer organizations overseas and the inclusion of the International

Boundary and Water Commission (IBWC) in our financial system and as part of our financial statements.

We know that strong financial management and internal controls provide the building blocks to support the transparency of operations and accountability to effectively manage limited resources. We have worked diligently to embrace the broadening landscape of financial compliance and reporting requirements and proactively incorporate them into our ongoing budgetary and financial operations. We recognize that the Annual Financial Reporting process is an essential discipline that has provided invaluable benefit over the past several years and will continue to do so into the future. At the same time, we want to continue working with OMB and the entire Federal Financial Community on the question of striking the right balance between data-driven and balance-sheet compliance and reasoned and value-added practices linked to meaningful reporting outcomes. The ultimate goal is to provide transparent, accurate, and timely financial data that translates into high-value financial information for decision-makers in furtherance of the Department's mission and financial transparency and confidence for the American public.

We are proud that the Department has received a clean audit opinion for 8 of the last 10 years. Last year's annual audit process was extremely difficult, as we engaged a new audit firm to conduct our annual review. Our experience told us that the worldwide operations and complexities of the Department in carrying out U.S. foreign policy activities were going to be a large challenge for a new firm to comprehend in the tight time frame required by the process. Unfortunately, this proved to be true resulting in an outcome that I believe does not truly reflect the full status of the Department's financial program.

Coming into this year, the Department faced no previously identified material weaknesses in its internal controls, and significant work was done to address the FY 2008-cited significant deficiencies in accounting for personal property, management of unliquidated obligations, reporting an unfunded actuarial liability for defined benefit supplemental pension plans for overseas locally employed staff, and strengthening the coordination of information between our systems. In addition, I am pleased to report that the Department maintains a robust system of internal controls overseen by senior leadership and administered by our Bureau of Resource Management. For FY 2009, the Secretary was able to provide an overall unqualified statement of assurance about the Department's internal controls in accordance with the Federal Managers' Financial Integrity Act, as well as an unqualified statement of assurance for internal controls over financial reporting.

However, the Department's new Independent Auditor issued an unqualified opinion on the Consolidated Statement of Net Cost and qualified opinions on the Consolidated Balance Sheet and Consolidated Statement of Changes in Net Position. The qualified opinions were based on the auditor's inability to satisfy itself that property and equipment was free of material misstatements as of Sept 30, 2009. Additionally, the new auditor was not able to satisfy itself as to whether the FY 2009 Combined Statement of Budget Resources (SBR) was free of material misstatement in time to meet the December 15 extended deadline granted by OMB, which resulted in a disclaimer of an audit opinion (or no opinion) on the SBR. The new auditor identified three material weaknesses and three significant deficiencies, as a result of its FY 2009 audit work. The material weaknesses relate to the need for an environmental liability restatement for the International Boundary and Water Commission's (IBWC), accounting for property and equipment and timely financial reporting. While we are disappointed with these results, we are committed to addressing these issues, implementing corrective action plans, and improving our process for this year.

I have included information on each of the material weaknesses, as part of this statement, for the record. I would like to thank the Subcommittee members for this opportunity to speak before you today and would be pleased to respond to any of your questions.

Environmental Liability Restatement

The FY 2009 independent audit cites a material weakness that the Department did not have a process in place to analyze and evaluate the International Boundary and Water Commission's (IBWC) financial information prior to its inclusion in the Department's consolidated financial statements. As noted, the Department consolidates financial amounts for the IBWC in our financial statements.

For over a decade, in addition to having its amounts included in our Department-wide financial statements, IBWC has issued separate, audited component financial statements that have received unqualified opinions. The audits are conducted by an independent CPA-firm engaged and overseen by the Office of Inspector General (OIG). It is these audited amounts that the Department has included in our financial statements with us first recording the environmental liability in FY 2004. In our Appendix A program[1], we strive to integrate internal control related activities within our control framework and leverage the internal reviews already being performed such as the separately audited and issued IBWC financial statements. Therefore, we saw no reason to question the IBWC amounts based on the issuance of the unqualified audit opinions on IBWC's financial statements by the OIG and independent auditor.

The Department requested, and the Office of the Inspector General convened, a meeting with the two independent auditors. Unfortunately, no consensus was reached in the meeting. Consequently, the Department submitted a technical inquiry to the Federal Accounting Standards Advisory Board (FASAB) with the understanding that the Department would follow FASAB's guidance. FASAB's determination was that no accounting liability exists or existed. The Department adopted this guidance and recorded the IBWC restatement

[1] In 2004, Appendix A of OMB Circular No. A-123 was added by OMB to improve governance and accountability for internal control over financial reporting in federal entities similar to the internal control requirements for publicly-traded companies contained in the Sarbanes-Oxley Act of 2002. The Circular A-123 requires that the agency head provide a separate assurance statement on the effectiveness of internal control over financial reporting, which is an addition to and also a component of the overall Federal Managers' Financial Integrity Act assurance statement.

accordingly, as recommended by our new Independent Auditor, which considered the restatement as an "automatic" material weakness because of the significance of the issue in its judgment. We are unaware of any adverse impact on users of our or the United States Government (USG) financial statements, or on IBWC and Department operations, as a result of the reporting of the environmental liability in our prior financial statements. The restatement had no effect on the Department's or IBWC's reporting of budgetary resources and we consider this material weakness resolved and hope the Independent Auditor reaches the same conclusion for the upcoming FY 2010 audit.

Property and Equipment

Based on the deficiencies our auditor identified in internal controls and the related potential risk of a material misstatement in the financial statements, our auditor assessed the Department's property accounting challenges as a material weakness in FY 2009. Our auditor elected to combine all of its findings related to all types of property and equipment rather than on an individual basis for real versus personal property. Regarding the material weaknesses, while we agree with the issues that were identified, we disagree with the severity of how they were assessed.

Land Valuation: The Department's restatement was to correct the valuation of two specific land holdings received from host governments in the mid-1900s. The land acquisitions represented the fair market value (FMV) of real property gifts to the Department from other countries. In 1996, the Department first valued these properties, this was the same time we started accounting for property under the CFO Act. These two properties were part of our valuation of all real property, representing over 3,400 assets. The methodology, developed by a leading CPA firm, and agreed to by the previous Independent Auditor, OIG, OMB and GAO, was to estimate the fair market value of the gifts using reasonable and consistent parameters such as comparable purchases, equivalent square footage, and Consumer Price Index (CPI) inflation indices in 1996 instead of when the gifts were first received. The methodology erred in that it used the FMV as of 1996 instead of as of the date the gift was received. In the intervening 12 years, we are unaware of any adverse impact on users of our financial statements, or on Department operations, as a result of the overstated estimated values that we reported. The restatement had no effect on the Department's statement of budgetary resources.

Capital Leases: We agree that we need to expand our processes to analyze property leases, and will work with our auditor to improve these processes.

Completeness and Accuracy of Real Property: The Department agrees that it has not completed a full reconciliation between the Department's real property management system (RPA/BMIS) and the Global Financial Management System's (GFMS) Fixed Assets (FA) module. These two systems serve different and multiple purposes, some of which intersect but many of which do not. Overseas buildings make up the largest balance of overseas real property assets—totaling a $6.4 billion (nearly 73%) net book value (NBV) of the $8.8 billion total NBV for overseas real property (excluding $1.5 billion of construction-in-process) at September 30, 2009. As a result of ongoing discussions with our auditor, we completed a reconciliation between RPA/BMIS and GFMS-FA for all government-owned Chancery and Consulate Buildings. These buildings comprise $5.5 billion (86%) of the total overseas buildings' $6.4 billion NBV. The reconciliation identified a variance of $12.2 million (NBV), a .22% (i.e., less than ¼ of 1%) discrepancy rate. In addition, the Department completed reconciliations of 20 of our international posts. In doing so, the Department identified several other immaterial differences and the need to strengthen the controls and procedures for the accounting for disposals and retirements of buildings. We will take actions to improve these processes and complete the reconciliations over the remaining balances in FY 2010.

Accounting for Personal Property: The Department acknowledges that our internal control structure contains several deficiencies related to the timeliness and accuracy of accounting for personal property. This past year we have continued to improve our controls. We established personal property contacts for each of our posts who work directly with the property accountability officer at that particular post to improve the timeliness of recording acquisitions and disposals. The contacts also assist the posts with various issues in recording personal property, such as proper fiscal data. Also, the frequency of the review of the asset detail by the Bureau of Resource Management (RM) was increased from the prior year. We will continue our efforts in FY 2010 to improve our accounting for personal property.

Accounting for Construction-In-Process (CIP): The Independent Auditor selected a statistical sample of current year CIP additions through March 31, 2009 and tested proper capitalization, accuracy of the amounts that were recorded, and the internal controls surrounding the process. The exceptions the auditor identified resulted in a $2.5 million net overstatement of the Department's balance of approximately $1.5 billion reported for property and equipment in interim reports during the year. The Department will work to strengthen our controls and oversight to ensure that CIP transactions are recorded accurately in those instances where the benefits of such additional oversight and controls exceed the cost to develop, implement and operate the improvements.

Timely Financial Reporting

As noted by the Independent Auditor, the Department compiles its financial statements through a multi-step process by using a combination of manual and automated procedures. The existing accounting system does not fully compile the required financial statements for several reasons, including not receiving information to include in the statements from external sources. For example, the Independent Auditor reported that journal vouchers totaling over $80.4 billion (this amount is calculated by adding all amounts together regardless of whether they are positive or negative) were recorded for the Balance Sheet, Statement of Net Costs, and Statement of Changes in Net Position. Of this amount, about $40 billion was to include financial information received in mid-to-late October (i.e., after the financial statement audit reporting year-end) from other agencies that have allocations of the Department's budget authority[2]. There are other similar type of activities areas for large portions of the remaining balances where it is more efficient to record the amounts at the agency-wide financial statement level (e.g., accrual estimates that are made to report accounts payable) than to attempt to record it to the detailed level that our financial system requires. The same is true for our Statement of Budgetary Resources preparation process. Regardless, the Department agrees that these processes can be improved, and will work with Independent Auditor to do so in FY 2010.

[2] Allocation transfers are legal delegations by one Federal agency ("parent") of its authority to obligate budget authority and outlay funds to another agency ("child"). A separate fund account (allocation account) is created in the U.S. Treasury as a subset of the parent fund account for tracking and reporting purposes. Subsequent obligations and outlays incurred by the child agency are charged to this allocation account as they execute the delegated activity on behalf of the parent agency. Generally, all financial activities related to allocation transfers (i.e., budget authority, obligations, and outlays) are reported in the financial statements of the parent agency (in this case the Department of State) under OMB's financial reporting guidance.

Questions for the Record Submitted to
Deputy Assistant Secretary James L. Millette by
Chairwoman Diane Watson
House Committee on Oversight and Government Reform
April 14, 2010

Question:

For several years, the agency's independent auditors have not been able to render an opinion on all or some of the State Department's financial statements by the reporting deadline. The primary reason cited by the auditors is that the department cannot provide timely or competent evidential matter that would allow them to perform certain audit procedures to satisfy requirements that the financial statements are free of material misstatements within the timeframes set by OMB.

What actions are needed for State to provide the auditors with timely and competent evidential matter? When is the timeframe for the agency to resolve this issue?

Answer:

It has been and continues to be a challenge for the Department to complete the audit and meet OMB's reporting deadline given the complexity of our global financial operations. This year's annual audit process was extremely difficult, as we engaged a new audit firm, Kearney & Company (Kearney), to conduct our annual review. During the FY 2009 audit, the Department responded to over 800 audit requests from Kearney.

The Department is taking a number of steps to improve our ability to provide timely and competent evidential matter. We are (1) expanding our resources dedicated to the audit liaison activities, (2) providing additional training to staff on how to prepare satisfactory responses to audit requests, and (3) reviewing our financial reporting processes to ensure we provide our final yearend statements to Kearney in an acceptable timeframe. All of these actions, along with a number of other actions, are included in our Corrective Action Plans (CAPs) that have been developed to address the financial reporting material weakness cited by Kearney in their FY 2009 Independent Auditor's Report on Internal Controls. The Department is working with the OIG and the Independent Auditor to ensure that our actions address the weaknesses.

Questions for the Record Submitted to
Deputy Assistant Secretary James L. Millette by
Chairwoman Diane Watson (#2)
House Committee on Oversight and Government Reform
April 14, 2010

Question Two:

GAO identified a serious material weakness in the 2009 consolidated financial statement demonstrating evidence and documentation for liabilities, commitments, and contingencies. Also, according to GAO's audit report, the federal government failed to "determine whether commitments and contingencies, including any related to treaties and other international agreements entered into to further the federal government's interests, were complete and properly reported.

Please share any changes that are already underway to address the weakness. Also, what other actions may be needed to resolve this weakness in the future?

Answer:

The Office of Management and Budget (OMB) is responsible in conjunction with the Chief Financial Officer's Council (CFOC), for issuing policy guidance relating to agency and government-wide financial reporting. Specifically, OMB Circular A-136 (A-136), Financial Reporting Requirements, is the central point of reference for Federal financial reporting guidance. In 2009, the Department participated in the OMB working group of the A-136 subcommittee of the CFOC. That working group recommended, and OMB issued, guidance in A-136 that requires agencies to disclose claims that may derive from treaties or international agreements.

The Department makes every effort to comply with all guidance from OMB with respect to the financial reporting of commitments and contingencies. This includes those associated with treaties and other international agreements. Accordingly, the Department took all necessary steps to ensure it identified and properly reported within our financial statements all claims associated with treaties and other international agreements for which the Department is responsible or for which we are providing the legal representation. Similarly, each Federal Agency with programs or projects established as the result of a treaty or other international agreement should be in a position to provide relevant financial information concerning any reportable contingencies. The Department has and will continue to work closely with Treasury and OMB to address this weakness.

Questions for the Record Submitted to
Deputy Assistant Secretary James L. Millette by
Chairwoman Diane Watson (#3)
House Committee on Oversight and Government Reform
April 14, 2010

Question Three:

Mr. Millette, you issued a letter when you served as Assistant Secretary for Resource Management and CFO in the 2009 agency financial report that stated "While we are extremely disappointed with the results of the 2009 audit, we are committed to addressing the items cited and to improving the audit process and results for FY 2010."

What initiatives are now underway in the State Department to resolve the material weaknesses in the FY 2009 audit, and to improve the audit process?

Answer:

The Independent Auditor's Report on Internal Controls cites three material weaknesses. These are for an International Boundary and Water Commission (IBWC) environmental liability restatement, property and equipment, and financial reporting. For the IBWC liability, the Department recorded the IBWC restatement in FY 2009 as recommended by our new Independent Auditor. We consider this material weakness resolved and hope the Independent Auditor reaches the same conclusion for the FY 2010 audit. For the other two material weaknesses, the Department has developed Corrective Action Plans (CAPs) to address these weaknesses by the end of FY 2010. The Department is working with the OIG and the Independent Auditor to ensure that our actions address the weaknesses. The Department also is working internally through senior management, our Management Control Steering Committee (that oversees the Department's internal controls program), and our Senior Assessment Team (that oversees the Department's internal controls over financial reporting) to ensure that critical milestones under the CAPs are achieved, and that efforts have a positive effect on the results of our FY 2010 financial statement audit.

Ms. WATSON. Thank you, Mr. Millette.
Let's now proceed with Mr. Easton.

STATEMENT OF MARK EASTON

Mr. EASTON. Thank you. Chairwoman Watson, Congressman Schock, distinguished members of the committee, thank you for the opportunity to appear today, and thank you especially for your continued support of America's armed forces. Having worn the uniform for many years, I personally appreciate that support.

I have submitted a statement for the record and would like to summarize it briefly.

I was asked to speak about the results of DOD's financial statement audit for fiscal year 2009. As you know, the department continues to receive a disclaimer of opinion on our consolidated financial statements, but we are making progress, although major challenges remain from allowing us to achieve an unqualified opinion.

For one thing, many of our systems are old and handle information in ways never intended to meet current audit standards. This problem makes financial auditability extremely difficult in a large organization that is functionally decentralized. Our legacy systems are also not well integrated, and they do not consistently collect data at the transaction level. This leads to business processes that tend to be non-standard, often lacking effective financial controls, and in these cases consistent application of additional compensating controls becomes critical.

The organizations and financial entities within DOD—and there are a few, getting larger and more complex—that have achieved auditability have been small enough to be able to overcome those deficiencies thus far.

The scale of our business operation adds to the problem. Every business day we obligate between $2 and $3 billion and handle hundreds of thousands of payment transactions, often under combat conditions. Given our size and mission requirements, it would be prohibitively costly to deploy an army of accountants to solve our problems manually. That is specifically why our current DOD business transformation is so critical, including the ongoing development of a business enterprise architecture and introduction of modern systems, both of which initiatives are well underway.

In short, we need a more disciplined automated business environment to maintain necessary controls cost effectively, but meanwhile we are making progress. The auditor's report on DOD's financial statements includes description of several material financial reporting weaknesses, and the department is following a revised strategy to address these weaknesses and improve the quality of the financial management information that are used each day by the department.

My written statement contains details of our strategy and progress and several current areas of weakness, including property management, environmental liabilities, military health care liabilities, funds bound with Treasury reconciliation, and intergovernmental transactions, but there is much more work to do.

In retrospect, earlier efforts, while making progress, lacked a coherent strategy to engage the full enterprise. Our new strategy was instituted a little bit less than a year ago by the department's new comptroller and CFO, who saw that DOD lacked a common goal and priorities in the audit readiness area.

As a result, he consulted with senior leaders and military departments and defense agency, our colleagues that you heard from at OMB, GAO, as well as congressional staff members, and last August we issued a memorandum that outlined the new priorities. These priorities focused on improving the quality, accuracy, and reliability of financial information that we use every day. This will focus on budgetary information, specifically that we use for resource allocation decisions, and the physical accountability, existence, and completeness of our assets that our war fighters rely upon.

So why is this going to be different? Congress has showed support for our new approach and identified that in the National Defense Authorization Act of 2010. Since then, we have taken specific steps to implement.

First, the initiative has the appropriate priority and full senior leadership support. It is 1 of our top 10 business priorities.

Second, we have a quarterly governance board that is chaired by the department's CFO. It includes a new office that has been established, our chief management officers and their representatives, as well as our comptrollers, in addition to having personal oversight by Deputy Secretary Lynn, our chief management officer.

Third, we have obtained resources to support our plan. Allocating resources for this kind of initiative competes with other war-fighting priorities, but as we have seen in southwest Asia, good, strong business practices are a force multiplier.

Fourth, we have made improvement of audit readiness among the components, one of our high-priority performance goals in the OMB priority, and we focus on that and measure each year.

Recognizing the importance of demonstrating measured progress, our plan includes interim goals that we will achieve, that we intend to achieve each year. We also will provide Congress with a semi-annual report on our financial improvement and audit readiness every May and November, and the first report will be issued within the next month.

In addition, we expect to report to Congress on a feasible approach for achieving fully auditable statements.

For now we are focusing, as I mentioned, on the financial information that are most useful to management. That will allow us to establish a firm foundation. That foundation is internal controls and installation of more capable business systems that will support our auditability, as well as the auditability of the Federal Government's statements.

As we look ahead and implement this approach, we believe it is important to also buildupon the existing strengths within Defense financial management. Our Defense financial managers are providing DOD's war fighters the resources and financial services needed to meet their national security objectives, and we are doing this around the world, including Iraq and Afghanistan.

We also have effective financial processes in many areas. Our payment processes produce timely and accurate payments in a very high percentage of cases. Interest payments have been dramatically reduced. Our process with which we distribute and account for funds has been externally validated. And so we have progress that we can buildupon.

My point is that we are doing much in our business well, but further improvements are necessary, and a revised focus on our business processes is using a financial auditor's lens.

In conclusion, our ongoing efforts to improve the quality of financial information will build on current strengths, producing changes that will ultimately result in a favorable opinion. We need to make improvements in the Department of Defense financial management while continuing to provide strong budget and financial information to our war fighters.

As the Deputy Chief Financial Officer, I am personally committed to this initiative. We are striving to support our national security mission by addressing these material weaknesses. Most importantly, we need to reinforce your confidence in our stewardship over public funds.

Thank you for inviting me today and for your support for our efforts. I welcome your questions.

[The prepared statement of Mr. Easton follows:]

Statement

of

Mark Easton
Deputy Chief Financial Officer
Department of Defense
before the

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

April 14, 2010

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Subcommittee on Government Management, Organization and Procurement

Chairwoman Watson, Ranking Member Bilbray, and Members of the Committee, thank you for the opportunity to appear before the Oversight and Government Reform Committee as you continue your oversight of the Federal Government's consolidated financial statements. In representing the Department of Defense (DoD) today, I want to start by thanking the Members of Congress for their support of our men and women in the military. We cannot meet the nation's national security needs without your assistance.

Defense Financial Management Today

I was asked to speak with you about the results of DoD's financial statement audit for Fiscal Year (FY) 2009. As you are well aware, the Department continues to receive a disclaimer of opinion on the consolidated financial statements. Progress has been made, but major challenges remain that impede us in achieving an unqualified audit opinion. I'll discuss some of those impediments, as well as the key material weaknesses that continue to exist, and our recently revised priorities for improving the quality of financial information that we report.

To begin with, our systems are old and handle or exchange information in ways that do not pass current audit standards. This is an inherent problem that has developed through the years as a result of growing DoD business operations within a large decentralized organization that is both mission (vs. business) oriented and functionally "stovepiped." The legacy systems are not integrated and they do not consistently collect data at the transaction level. This leads to business processes that tend to be non-standard, often lacking effective financial controls. In these cases, the consistent application of required internal controls becomes critical. The organizations and financial entities within DoD that have achieved auditability have been small enough to be able to overcome these deficiencies.

The scale of business operations exacerbates these challenges. DoD's enormous size and geographical dispersion also greatly complicate the challenges associated with meeting audit standards. Every business day, we obligate an average of $2 billion to $3 billion and handle hundreds of thousands of payment transactions. Some of these financial transactions take place in war zones. Because of our size and mission requirements, it would be prohibitively costly to deploy an army of accountants to solve our problems manually. This is why our current effort supporting DoD business transformation is so critical, including the recent development of a business enterprise architecture, along with the implementation of modern, compliant systems. We need a more disciplined, automated business environment to cost-effectively maintain the necessary controls. In the meantime, we are also addressing our current material weaknesses.

Addressing Auditor-Identified Weaknesses

The Department continues to make progress toward achieving auditability. The auditor's report on DoD's financial statements includes descriptions of several material financial reporting weaknesses. The Department is following a revised strategy to address these weaknesses and improve financial and management information. I will discuss the revised strategy in more detail later, but would like to specifically describe some of the efforts to fix these weaknesses now.

- **Property, Plant and Equipment (PP&E) and Related Inventories.** The Department maintains the majority of total property in this category across the federal government. The inability of the Department's legacy systems and processes to identify, capture and report the full cost of PP&E—along with the lack of sufficient supporting acquisition documentation—results in unreliable asset information. To meet the most pressing needs of the Department for effective management of PP&E and support of the warfighter, the Department has developed and is executing a plan of action to validate the existence and completeness of mission-critical assets as a first priority. These assets include Military and General Equipment, Real Property, Inventory and Operating Materiels and Supplies. This means that we are performing physical inventories to support our accountable property records and to ensure mission-critical property is properly recorded, to include transactional audit trails.

- We will then make full use of a new accounting standard issued by the Federal Accounting Standards Advisory Board allowing estimates for valuing property. The new accounting standard will reduce the cost of the Department's efforts to eliminate the PP&E material weakness. In addition, the Enterprise Resource Planning Systems (ERPs) being implemented by the Military Departments can potentially provide the capability to capture and report the cost of PP&E and inventories.

- **Environmental and Disposal Liabilities.** The Department's internal controls for reporting environmental liabilities do not provide reasonable assurance that clean-up costs are fully identified, consistently estimated, and appropriately reported. The Department is fully committed to identifying and disposing of its environmental liabilities and has invested significant effort in improving policy and guidance, business processes, training and cleanup cost estimate procedures. Recent results have been encouraging. During 2009, the Army revised its environmental liabilities for demilitarization of chemical weapons based on updated costs. The Navy also received a favorable audit review from the DoD Inspector General on the weapons systems component of environmental and disposal liabilities. The Navy also asserted audit readiness of the Defense Environmental Restoration Program, Other Environmental Liabilities, and Base Realignment and Closure components of environmental liabilities. Finally, all Military Services began recognizing asbestos clean-up costs in 2009.

- **Military Healthcare Liabilities.** Weaknesses in financial processes related to coding for patient visits to military treatment facilities negatively impact the accuracy of these costs. As a result, this information cannot be relied upon to produce reliable reports and estimates of military health care liabilities. While implementation of new business systems should strengthen these processes in the long-term, the Department is considering revising the method of estimating health care liabilities. This alternative would use pre-established standard rates per patient, based on payment practices used by commercial health care providers to compute the health care liabilities instead of the current complex formula. These estimates should resolve the specific reporting weakness and permit the federal government to more accurately report these liabilities.

- **Fund Balance with Treasury.** DoD is unable to consistently reconcile account balances with Treasury at the transaction level across the Department. Legacy feeder systems capture and report business events and pass the related financial information to accounting systems. However, minimal front-end edits make data quality maintenance difficult. In some cases, these systems do not always pass transaction-level detail to the financial systems, or that detail is not maintained in the financial general ledger. To address these weaknesses in the near term, the Department is implementing an automated transaction reconciliation capability for each Service as well as one for the Defense Agencies. These reconciliations, combined with supporting documentation, will allow the Department to balance its accounts with Treasury without making unsupported adjustments. This approach is beginning to show results. For example, the Navy will expand its existing reconciliation capability to include all transaction types and systems while also testing for completeness of supporting documentation. The Marine Corps is already demonstrating this capability as part of its FY 2010 audit. The Air Force plans to use its automated capability to reconcile all appropriations, beginning with FY 2008, which will ultimately support the required transactional reconciliations. Reconciliation of these accounts requires historical records supporting individual transactions that may be difficult or impossible to obtain.

- **Intragovernmental Eliminations**. DoD is unable to reconcile buyer and seller intragovernmental transactions because of limitations in the data available in DoD legacy accounting systems and data quality issues. Our federal government trading partners also have similar issues, resulting in differences and adjustments that cannot be verified. The Department is working initially with our largest trading partners to develop a framework for data exchange as an interim (but manual) solution focused on reducing intragovernmental differences in the near term. We are also collaborating with Treasury, the Office of Management and Budget (OMB), and our trading partners to develop and implement common solutions based on standard business processes, data elements, and systems that capture the transaction level detail needed to reconcile intragovernmental activity.

- **Unsupported Accounting Entries**. This weakness is a reflection of many of the weaknesses that have already been discussed. Current business rules that are required to prepare consolidated statements in this very challenging legacy environment result in adjustments that cannot be properly supported at a transaction level, as an auditor would expect to see. For example, intragovernmental activity is a root cause for many of these adjustments, as are legacy systems that cannot maintain both budgetary and proprietary ledger postings. Our solutions for all weaknesses now focus on posting and maintaining transaction-level detail that will minimize these entries.

Our current disclaimer of opinion reflects the inherent weaknesses of a business environment that is badly in need of modernization. We are partnering with the Department's Chief Management Officers to implement more effective business systems and engage functional leaders across the enterprise to effect meaningful change. A significant initiative is the DoD's Financial Improvement and Audit Readiness (FIAR) effort that focuses on improving the quality and accuracy of the data used for management decisions. While not all of the material weaknesses directly relate to the priorities of the FIAR effort, we are committed to addressing the remaining material weaknesses to achieve an unqualified opinion.

Our New Approach—Improve the Quality of the Information We Use Every Day

This approach was instituted a year ago by DoD's new Under Secretary (Comptroller) and CFO. He was convinced that the Department lacked a common goal or priorities in the audit readiness area. Instead, the Military Departments were pursuing their own initiatives and doing so with widely varying degrees of commitment and resources. With this approach, he concluded that the Department, as a whole, would never achieve success. Also, the Department's dates for achieving audit readiness were not credible. Even the staff did not believe them.

Shortly after taking office, our CFO began consultations regarding a new approach with senior leaders in his office and in the Military Departments and Defense agencies. We also discussed a new approach with OMB, the Government Accountability Office, and some staff members in the Congress. In August of last year, a memorandum was issued outlining the new approach. It focuses on improving the quality, accuracy and reliability of the financial and asset information we use every day to manage the Department. Specifically, we plan to focus on two types of information—budgetary information and existence and completeness of assets.

Budgetary information is critical to leadership at all levels—program managers, program executive officers, base commanders, Service Chiefs, Service Secretaries, and the Secretary of Defense —as they make operational and resource allocation decisions. Our new approach focuses on improving budgetary information, which should lead to audit readiness for our Statements of Budgetary Resources.

The financial audit elements of "existence and completeness" translate directly into knowing what weapons and equipment we have, and their locations, so we can use this equipment in combat and ensure that our acquisition community is buying only what DoD needs. Existence and completeness, key financial audit elements for our balance sheet assets, represent the second priority area under the new approach.

The FY 2010 National Defense Authorization Act accommodates this new approach in the audit readiness legislation. We appreciate the support of the Congress for our new approach, and we have taken steps to implement it:

- First, we placed a reasonable priority on the effort. Financial improvement and audit readiness must be an agency-wide priority that has the support of senior leaders. This initiative is now one of DoD's top-ten business priorities.

- Second, we created a governance structure. We have a governance board chaired by the CFO that meets quarterly and includes the Deputy Chief Management Officers (CMOs) throughout the Department. The Chief Management Officer of the DoD and each of the Service CMOs have been briefed on this topic. I personally conduct weekly meetings with the heads of financial operations in the Military Departments, and these meetings regularly discuss issues related to financial improvement and audit readiness.

- Third, we obtained resources. Nothing is harder to do in DoD than acquiring resources for business process improvements, because these dollars compete, as they should, with direct warfighter needs. But we ensured that increased resources are devoted to high-priority financial improvement efforts, including business operations in Afghanistan.

- Fourth, we made improvement of audit readiness among individual DoD components a DoD High-Priority Performance Goal, with progress measurements described in the President's FY 2011 Budget's Analytical Perspectives volume.

To demonstrate progress, our plan includes interim goals that can be achieved by FY 2012. We plan a DoD-wide examination and validation of our funds control and distribution process (known in audit terms as "appropriations received"). Periodic validation of appropriations received will reassure the Congress that we are controlling our funds carefully and in ways that ensure we comply with the laws you enact. A clean opinion on the FY 2010 Marine Corps Statement of Budgetary Resources is a key interim goal. We will learn much from this effort. We have asked the Military Departments to identify areas that can be validated by FY 2012, including audit readiness for fund balance with Treasury.

We owe the Congress more detail on our plan. The FY 2010 National Defense Authorization Act requires that the CFO provide a semi-annual report on financial improvement and audit readiness in May and November. We are currently finalizing the May 2010 report, which will provide considerably more detail.

The FY 2010 National Defense Authorization Act not only requires reports; it requires DoD to have fully auditable financial statements by 2017. Under current audit rules, meeting that date would require the expenditure of large sums of DoD dollars to acquire and improve information. My understanding is that non-defense financial managers are also expressing concern about the costs of maintaining certain information in audit-ready status—information that is rarely used to manage. The CFO Council is reviewing alternative federal reporting models that may increase transparency while maintaining sound internal controls. After that review is complete, and after consulting with the appropriate stakeholders, we expect to identify and report to the Congress on a feasible approach to achieving fully auditable statements. For now, we are focusing on improving the financial information that we use to manage and the foundation that we are building—sound internal controls and implementation of more capable business systems—to support future auditability requirements for both DoD and the consolidated federal government financial statements.

Conclusion

As we look ahead and implement this new approach, we believe it is important to recognize the existing strengths within Defense's financial management. Most importantly, Defense financial managers are successfully providing DoD's warfighters with the resources and financial services necessary to meet our national security objectives. We are doing this around the world, including in Afghanistan and Iraq. Additionally, we have sound and effective financial processes in key areas. Our payment processes produce timely and accurate payments in a very high percentage of cases. Interest payments have been dramatically reduced in recent years, and our summary reconciliation rates with Treasury are very high. DoD also has a sound process for funds control and distribution, which has been periodically validated by external auditors. This validation ensures that funds are distributed in compliance with laws and regulations. After distribution, laws that are regularly enforced require that funds be obligated exactly as distributed. I believe this should reassure the Congress that DoD is spending its appropriations in accordance with the laws you enact. Our ongoing effort to improve the quality of financial information will build on these strengths while also supporting the elements of financial auditability that will be reflected in improved financial reporting. We need this to reinforce the confidence of our stakeholders in our stewardship over government funds.

Moreover, we need to make improvements in DoD financial management while continuing to provide strong budget and financial information to our warfighters. I want the Committee to know that I am personally committed to this effort, and we will produce results that better support our national security mission and contribute to resolving material weaknesses that currently preclude a clean opinion on the federal government's consolidated financial statements.

Ms. WATSON. I would like to thank each one of the witnesses in this first panel.

We are now going to move to the question period and proceed under the 5-minute rule. I am going to start the questioning, and my first question, comment and then question, will be to Mr. Dodaro, and then we will move to the other witnesses, as well.

GAO has frequently cited the Federal Government's ineffective process for preparing the consolidated financial statements as a major impediment that precludes the issuance of an audit opinion. Which agencies have been relatively more successful in dealing with this challenge? I heard several of the witnesses refer to Treasury Department, but what have the agencies done differently, and could their experiences be used to better address this problem in other agencies? And when do you anticipate that this material weakness will be resolved and no longer cited in the U.S. Government reports?

Mr. DODARO. The issue of the preparation of the consolidated financial statements has really three dimensions to it. One, you need to have good information at the individual agencies. As we have heard this morning, the Department of Defense, Homeland Security, NASA, and State have not been able to get unqualified opinions, some for many years, so that is one issue. You have to have the foundation in the individual agencies.

Second is that the individual agency's financial statements need to be consistent with Treasury's accumulated financial reporting that it has in place, and so far there have been some difficulties reconciling the audited financial statements of individual deposition and agencies with Treasury's records.

Ms. WATSON. Are there firewalls between these agencies? Are they not sharing? What do you find?

Mr. DODARO. There is sharing of information, but part of the problem is that there are different systems——

Ms. WATSON. Tracking.

Mr. DODARO [continuing]. That keep the records. This is particularly problematic in the agencies resolving differences in these intergovernmental transactions, themselves, and there are tens of billions, if not more, transactions that take place, and for a decade or more now different things have been tried in order to get the agencies to reach agreement among themselves. OMB and Treasury have tried to facilitate those type of reconciliations, and some progress has been made, but not enough in that area.

Now, some of the new ideas that OMB and Treasury are beginning in this new innovation office that they are creating to have more central accounting systems with standardized definitions and having data from the vendors offers a lot of promise to use modern technology to solve this issue. And unless there are better technical applications or the technology, as Congressman Issa mentioned—I mean, this problem is so pervasive, and you have so many different systems it is hard to do that reconciliation.

So I am hopeful that the concepts underpinning some of these new initiatives that OMB and Treasury are just starting—I know they know the issues very well. The solutions have eluded them to date, but I am hopeful with new applications and technology that they can be solved.

We have had a decade of experience now trying to solve this with the agencies working among themselves and that hasn't proven to be fruitful.

Ms. WATSON. Well, we know technology is really progressing, keeping up with it——

Mr. DODARO. Right.

Ms. WATSON [continuing]. And being that it paid for it is one of the stumbling blocks.

In testimony before this committee last summer, you expressed concern about the January 9, 2009, revision of OMB Circular No. A–27. Do you remember that? Financial management systems? And noting that the revised circular sustainability reduces the scope and the rigor of compliance testing for agency and financial management systems?

Mr. DODARO. Yes. My understanding is that there will be further refinements to that circular coming out shortly, and we are going to take a look at that. And once we make that assessment, we would be happy to provide our assessment to the subcommittee.

Ms. WATSON. That would be great.

How might the closing of the financial systems integration office further affect agency compliance with fiscal year 2010 financial reporting requirements? Were you aware?

Mr. DODARO. Yes. Yes, I was aware that action was going to take place. We closely coordinate with OMB and Treasury to the joint financial management improvement program. I believe that the concerns underpinning that and the fact that there have been a lot of expenditures made to improvement systems, they haven't always made the necessary improvements.

And I believe that this needs to be monitored carefully going forward. I think that, again, the concepts that OMB and Treasury are moving to I think are worthy concepts, but a lot will rely on the implementation of the programs. And there will have to be careful attention to make sure that the standards that were in place before are adhered to.

But I think the fundamental premise that technology was moving faster than the agencies could keep up with was a correct interpretation of the situation, and I do think that their new efforts can be effective, but a lot will depend on the implementation and the details.

Ms. WATSON. Thank you so much.

We are now going to proceed on with the minority member, Mr. Schock.

Mr. SCHOCK. Thank you, Madam Chairman. And thank you to our panelists for your remarks.

Obviously, you are the messengers, but as our constituents want to hold us accountable back home, we have to look to you to be accountable for the oversight.

There is so much content in this, and I hope this is, as Mr. Issa said, the first of many hearings on this issue, because one of the numbers that is glaring to me is this $98 billion figure. I am reminded of a year ago when the President brought together his Cabinet and said, we are going to begin by tackling the budget deficit, by asking my Cabinet members to bring forward $100 million in voluntary savings for next year over this year.

Now, I don't know where we are with getting those recommended $100 million in potential savings, but I know one thing: $100 million is a pittance compared to $100 billion. And with all the talk this year with the health care reform bill and cutting out fraud, waste, and abuse, it would seem to me one of the biggest abuses in these discoveries is the fact that we potentially paid $98 billion of taxpayer money to people who shouldn't have received the money.

I would feel a little better if we were moving in the right direction, but it is almost a 30 percent increase over the last year's estimate of unnecessary payments.

So I guess my question is, to Mr. Dodaro and Mr. Werfel, if you feel comfortable piping in, is: what are we doing and what do we need to do to ensure that, No. 1, we are moving in the right direction and hopefully some day we are not spending nearly $100 billion of taxpayer money to folks who shouldn't receive this. Clearly, this wouldn't be acceptable in the private sector, and I think tribe just perpetuates the notion that many of our taxpayers and constituents back home have that the Federal Government doesn't do a very good job of managing their tax dollars.

Mr. DODARO. Thank you, Congressman Schock. You are right. This situation is not acceptable and there needs to be action taken to address it. One of the things I would point out is that one of the success stories coming out of the CFO Act and the emphasis on financial statements has been the identification and quantification of improper payments. Prior to that, there was really no quantification of it.

Now, we are moving in the right direction. What needs to be done is, No. 1, not all programs that should be reporting improper payments are reporting improper payments yet. Part D in the Medicare program, for example, is not yet quantifying improper payments, and there is a number of other areas.

No. 2, there needs to be consistent methodologies used over a period of time so that you can have comparable information. Right now, one of the big reasons for the increase has been a change in the methodology used under the Medicare program and the improper payments.

Third, there needs to be key accountability, targets, and metrics expressed for each of these individual programs, because some of them have a long history of data, theirs have just one data point. I might point out—and I am sure Mr. Werfel elaborated on it—is that OMB has just put out guidance implementing an executive order to name accountable officials for each of the areas where there are improper payments, to put a dashboard in place and metrix, and to report targets for reducing improper payments.

I am very encouraged by those, and I believe those will provide the foundation for further evaluations or progress.

Mr. SCHOCK. Let me followup to that. I am aware of the Executive order, but from my perspective this doesn't seem to be a problem of not having the appropriate number of experts. In other words, I don't have reason to suggest that the people who are working on this in pastures who have attempted to reduce the number organization improper payments were not capable of doing so. And I am asking for your opinion on this.

Mr. DODARO. Right.

Mr. SCHOCK. I might suggest that perhaps it is the data in the systems that we are using to be able to hold these different agencies internally, themselves, accountable for how they are paying out, whether it is their POs or their accounting systems. And so my question would be: do you think it would be appropriate for Congress to mandate a universal accounting system and collection of data so that across the systems, across these different departments they would all be using a similar mechanism, which would not only allow them to be held accountable but, more importantly, would allow folks like yourself, Mr. Werfel, and all the respective parties to appropriately audit them and better hold them accountable.

Mr. DODARO. The systems issues are definitely integral to solving the problem, but each of the programs are a little bit different, so I think Congress should begin examining each of the individual programs and make sure they have the appropriate systems in place.

Now, part of the dilemma in solving this problem is the $98 billion is an estimate, so it is not an accumulation of a lot of specific improper payments that then you could go pursue, and there is a lot of reasons. In some cases they are paying people who aren't eligible for the program. In other cases there are duplicate payments or overpayments. There are a lot of reasons and there are a lot of different reasons for the different programs.

But you are right: better systems are the key, but they need to be tailored to the specific types of programs.

Ms. WATSON. Thank you. Your time is up.

Mr. Connolly.

Mr. CONNOLLY. Thank you, Madam Chairwoman.

Before you start my time, Mr. Dodaro, I noticed you may have some back problems, and if you would be more comfortable answering my questions standing up, please feel free to do so.

Mr. DODARO. I appreciate your consideration.

Mr. CONNOLLY. I am a fellow back sufferer.

Thank you, Madam Chairwoman.

I am so glad my friend and colleague from Illinois brought up the issue of overpayments. Don't I recall a GAO report last fall that cited $61 billion in overpayments to Medicare?

Mr. DODARO. I believe the number last year for Medicare and Medicaid was close to the 40-some billion. Let me just check. OK, it was over 50.

Mr. CONNOLLY. Over 50?

Mr. DODARO. Right.

Mr. CONNOLLY. And don't I recall that the health care reform bill we passed recently in part is financed by trying to get our arms around some of those overpayments, a substantial portion of those overpayments; is that not true?

Mr. DODARO. I believe there are efforts. I am not as—I am not completely sure on that answer. I know there is a lot of effort to try to reduce some of the waste in those programs.

Mr. CONNOLLY. Right. I just find it ironic that some on the other side of the aisle expressed enormous skepticism about our ability to finance health care by getting our arms around overpayments. It had to. It had to, in fact, reduce benefits, when, in fact, overpayments are substantial, and if we can get our arms around those overpayments—and I believe the health care reform bill, by the way, enhances enforcement to try to get at these overpayments—as a matter of fact, we can reduce Medicare and Medicaid expenditures without eating into benefits.

In theory would that not be true, Mr. Dodaro?

Mr. DODARO. There is definitely action that can be taken to eliminate waste and fraud in the health care area. I think that is well demonstrated.

Mr. CONNOLLY. Thank you.

Let me ask a question, maybe to both you and Mr. Gregg. Would it be fair to say that one of the chief, if not the chief, contributing factor to deficits, growing deficits in the out years, is, in fact, health care costs to the Federal budget?

Mr. DODARO. Definitely. Rising health care costs and changing demographics, but the health care cost, rising health care costs, are the primary driver. I will ask Mr. Gregg.

Mr. GREGG. I think it is a series of things, Congressman, everything from Medicare, Medicaid, Social Security, Defense, and on down the list. For fiscal year 2009, also unemployment was exceptionally high. And we also had, like, $460 billion of revenues that had been there the previous year but didn't show up because of the economy. So it is a long list of things. Certainly health care is one of the big drivers.

Mr. CONNOLLY. You saw the CBO report that said that in the first 10 years the health care reform bill we passed in Congress would reduce the total debt by about $138 billion, but in the second 10 years would reduce it by at least $1.2 trillion. Any reason to doubt those numbers?

Mr. GREGG. I am not an expert in that, but CBO is well respected, so I think they have a lot of credibility.

Mr. CONNOLLY. Just interested. Have either of you ever seen any legislation passed by Congress before that has ever been projected to reduce the deficit by $1.2 trillion, combined $1.3 trillion plus over 20 years?

Mr. GREGG. I can't say that I have.

Mr. DODARO. I can't think of anything offhand.

Mr. CONNOLLY. I can't either. Thank you.

Mr. Dodaro, if you look at declining, where we were as a percentage of GDP in terms of debt immediately after World War II, and you look at the next 30- or even 40-year time period, would it be fair to say that actually we brought down the debt as a percentage of GDP, primarily through a combination of economic growth and other control measures, not so much by cutting spending?

Mr. DODARO. If my memory serves me right in terms of historical purposes, there was considerable economic growth, which was a contributing factor, but I do think there were fiscal discipline or approaches that were put in place, as well, to help control and contain and make appropriate decisions from a fiscal prudence standpoint.

Mr. CONNOLLY. But I mean if you looked at Federal spending patterns, for example, in the 1960's, big spurt in growth.

Mr. DODARO. There was a big spurt in growth, but there were also small surpluses and——

Mr. CONNOLLY. But we weren't slashing Federal spending, is my point, in that 40-year time period under either Republican or Democratic administrations.

Mr. DODARO. No, but there was control in making sure that the Federal Government spending decisions would be close to anticipated revenue collection during that period of time. Otherwise, you wouldn't have had that pattern of growth. That is all I am saying. Economic growth is important and will be important going forward to address this problem, but economic growth alone, in our opinion, won't solve it by itself.

Mr. CONNOLLY. I would agree with you, of course, but I am only getting at the historic record would suggest we did not bring down the debt as a percentage of GDP by massive spending cuts. That is not what the record shows.

Mr. DODARO. Well, there is a lot of reasons for it. I agree with that.

Mr. CONNOLLY. Thank you. I believe my time is up. I call on Mr. Cuellar from Texas.

Mr. CUELLAR. Thank you very much. I will save my questions for the next set of panelists, but I do want to thank all of you for being here. I think the issues that you all have brought up are so important for all of us and I do want to thank all of you, but I want to reserve my questions for the next panel.

Ms. WATSON. I have just a few more questions I would like to address for the panel, and so we will do a second round. If there is anything else that you would like to chime in on, please let me know.

Since improper payments have been mentioned several times, OMB recently issued guidance for the implementation of Executive Order 13520, reducing improper payments. What impact do you think these additional tools would likely have on efforts not only to reduce but to prevent future improper payments? GAO has recommended that OMB take actions to ensure that smaller programs with higher risks are covered by the Single Audit Act, so any one of you that would like to?

Mr. WERFEL. Ms. Chairwoman, I will address that question.

There has been a good discussion so far on improper payments. I would like to, before I get to your direct question, just respond to some of the earlier comments that were made.

First of all, one of the important—let's start with the premise that $98 billion in improper payments is completely unacceptable and clear action needs to be taken. One of the things that has caused that number to go up over time has been basically an increase in outlays, increase in unemployment outlays, so even if you have, for example, in the unemployment program a constant error rate of 10 percent, as the numbers go up in terms of the outlays the improper payment total goes up, and we have seen that both in the health care realm and unemployment insurance and other ways.

Another reason why the number goes up is because we are measuring more programs and we are getting better at detecting where our errors are and uncovering them, so the $98 billion is not good news, but within that construct there are some positive elements, in particular our ability to find and root out these errors more effectively.

We respect to the Executive order, what we have done under the Executive order is take the collective 8 years of experience managing the improper payments problem, since the Improper Payments Information Act was first brought to law in 2002, and tried to define what we believe to be the most effective targeted solutions that are going to move the dial.

Mr. Dodaro mentioned assigning a senior accountable official in each organization for improper payments, and we have already seen that has engaged a higher level in senior leadership attention to the issue.

We have also looked a lot at incentives, and the Executive order tackles this issue of incentives in terms of one of the major payers in improper payments are State governments. Many of these programs, for example Medicaid and others, are administered through State governments, and it is important that the State government officials, who are playing such a critical role in implementing these programs, feel accountable and incentivized to try to measure and do more on their error. So one of the things the Executive order does, it establishes a working group, an intergovernmental working group, to define and identify different incentives that can be put in place to drive States to do more to drive errors down.

We are also looking at incentives for contractors to report improper payments that are paid to them earlier in the process so they are part of the solution as we work to prevent these errors.

And, Ms. Chairwoman, you mentioned the single audit process. One of the things that the Executive order does is it recognizes that the single audit, which is the main driver which Federal funds are evaluated, the appropriateness of how they are spent is done through the single audit at the State and local level.

And if you look at the single audit today—and we have started to examine it very closely—a lot of the questions that are scrutinized during the single audit process don't relate to the bottom line of whether the money was paid out correctly and for the right purposes. There are a lot of what could be arguably termed extraneous questions during the single audit process about other compliance elements which aren't essential to the bottom line question of whether the money is being paid out correctly.

So what we are looking to do is looking at ways of shifting the footprint or the focus of the single audit so that we are pounding away at the question of whether these moneys were spent correctly and in the right amount for the right purpose, rather than some of the other what I would argue are less central compliance issues, because in any audit—and I am sure Mr. Dodaro would concur with this—there is limited resources, so you have to use a risk management approach in terms of where you scrutinize.

We believe at OMB that the single audit is a place where we can really shift our emphasis to improper payments in a way that is going to improve our results in this area.

Ms. WATSON. We have many, many more questions that we would like to ask, but being aware of the time we are going to move to the second panel.

I want to thank each and every one of you for your testimony. Other questions we can send to you in writing, and we would hope to get a response that we will share with the committee and with the full committee.

Thank you so very much.

It is the policy in Government and Reform to swear in all the witnesses before you testify, and I would like to ask all of you to please stand and raise your right hands.

[Witnesses sworn.]

Ms. WATSON. Let the record reflect that the witnesses answered in the affirmative.

I will now take a moment to introduce our distinguished witnesses.

Mr. John Barton is the manager of the public information and report production for the Texas Legislative Board, where he has worked since 1984. He oversees the preparation of budget evaluation and performance related publications and analysis for the Texas Legislature. You have a counterpart in California by the name of John Barton. You might know him. His brother was here in the House.

Mr. Michael J. Hettinger is director of practice planning and marketing for the Grant Thornton LLPD's global public sector and practice. Mr. Hettinger oversees firm-wide strategic business planning and Federal marketing activities. Previously, Mr. Hettinger served as staff director of the House Committee on Oversight and Government Reform's Subcommittee on Government Management, Finance, and Accountability, where he developed and helped to pass the Department of Homeland Security Financial Accountability Act. He also worked as a senior lobbyist at Patton Boggs LLP, and as chief of staff to former Representative Tom Davis of Virginia.

Veronique de Rugy earned her doctorate in economics at the University of Paris and the Patheon Sarbonne in the areas of public choice and public finance. She currently serves as the senior research fellow at the Mercatus Center at George Mason University, where she also previously served as a post-doctoral fellow and visiting scholar.

I welcome all of you and thank you for your patience. I ask that each one of the witnesses now give a brief summary of your testimony and keep the summary, if you can, under 5 minutes in duration, because your complete written statement will be included in the hearing record.

Mr. Barton, you may proceed.

STATEMENTS OF JOHN BARTON, MANAGER OF PUBLIC INFORMATION, TEXAS LEGISLATIVE BUDGET BOARD; MICHAEL J. HETTINGER, DIRECTOR OF PRACTICE PLANNING AND MARKETING, GRANT THORNTON LLP; AND VERONIQUE DE RUGY, PH.D., SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

STATEMENT OF JOHN BARTON

Mr. BARTON. Chairwoman Watson, Mr. Cuellar, good morning. My name is John Barton and I am the public information officer and manager of report production for the Texas Legislative Budget Board. I have been on the staff of this nonpartisan, highly respected legislative agency for the past 25 years. During this time, we have developed and implemented numerous good government accountability initiatives. Please see Exhibit A.

I am privileged to serve as a resource witness on H.R. 2142. This morning I would like to touch upon three of the good government accountability initiatives that were developed and implemented during the 1990's, namely Statewide strategic planning, performance budgeting, and performance monitoring. These initiatives are the foundation of our fiscal accountability system, a system that Representative Cuellar, as sponsor of H.R. 2142, championed in Texas throughout the 1990's.

In 1991, Texas faced a massive budget deficit. To engender support for a tax bill and a response to a growing sense of frustration on the part of the legislature and the public as to what are we getting for our money, three inter-dependent initiatives were subsequently enacted: strategic planning, performance budgeting, and performance monitoring. Please see Exhibit B.

The strategic planning process requires State agencies to identify the goals and strategies and performance measures that constitute the basis for the biennial request for appropriations. The strategic planning process is a long-term iterative and future oriented process of assessment, goal setting, and decisionmaking. An agency's strategic plan is used as a starting point for developing the agency's budget structure, i.e., goals, strategies, measurements, measure definitions, and items of appropriation. Please see Exhibit C.

The development of performance budgets occurred during the legislative appropriations process. Performance measures, definitions, and targets were established for each item of appropriation, and each agency develops a budget structure that includes its performance measures and definitions and targets. Please see Exhibit D for an example.

Once the State budget is enacted, performance monitoring involves each agency reporting to the Legislative Budget Board electronically every quarter on their success in achieving agency-specific performance targets. To ensure the integrity of the performance information that is being reported, measure certification audits are conducted by the State auditor's office on an ongoing basis. Assessments of how well agencies are able to achieve their performance targets provide essential information for the next iteration of the biennial appropriations and strategic planning process.

After more than 15 years of daily use, we have learned many important lessons about our fiscal accountability system. For example, our system enables legislators and citizens alike to, one, understand what we are getting for our money, two, assess agency and program performance, and, three, improve and ensure greater governmental accountability and transparency. That said, the system cannot and should not be used to abdicate the hard policy budget and political decisions that we as public servants have an obligation to make in the best interest of the public and the taxpayer.

I should note that Texas' fiscal accountability system is the foremost system of its type in the United States. During the past 15 years, 28 delegations of foreign government officials representing 38 countries have traveled to Austin to learn how Texas has integrated strategic planning, performance budgeting, and performance monitoring into a seamless system that promotes Statewide accountability, effectiveness, and efficiency, and, most importantly, extols the many virtues of budget transparency.

I would be delighted to respond to any questions. Thank you very much.

[The prepared statement of Mr. Barton follows:]

U.S. House of Representatives

Committee on Oversight and Government Reform

Government Management, Organization, and Procurement Subcommittee

14 April 2010

TESTIMONY BY JOHN BARTON
Texas Legislative Budget Board

H.R. 2142
The Government Efficiency, Effectiveness, and Performance Improvement Act of 2009

Madam Chairwoman and Members:

Good morning.

My name is John Barton, and I am the Public Information Officer and Manager of Report Production for the Texas Legislative Budget Board. I have been on the staff of this nonpartisan, highly respected legislative agency for the past 25 years. During this time, we have developed and implemented numerous Good Government Accountability initiatives. (Please see Exhibit A)

I am privileged to serve as a resource witness on H.R. 2142.

This morning, I would like to touch upon three of the Good Government Accountability initiatives that were developed and implemented during the early 1990s—namely statewide strategic planning, performance budgeting, and performance monitoring. These initiatives are the foundation of our fiscal accountability system—a system that Representative Cuellar, a sponsor of H.R. 2142, championed in Texas throughout the 1990s.

In 1991, Texas faced a massive budget shortfall. To engender support for a tax bill, and in response to a growing sense of frustration on the part of the Legislature and the public as to "What are we getting for our money?", three interdependent initiatives were subsequently enacted: Strategic Planning, Performance Budgeting, and Performance Monitoring. (Please see Exhibit B)

The strategic planning process requires state agencies to identify the goals and strategies and performance measures that constitute the basis for their biennial request for appropriations. The strategic planning process is a long-term iterative, and future-oriented process of assessment, goal setting and decision-making. An agency's strategic plan is used as a starting point for developing the agency's budget structure, (i.e., goals, strategies, measures, measure definitions, and other items of appropriation). (Please see Exhibit C)

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After more than 15 years of daily use, we have learned many important lessons about our fiscal accountability system. For example, our system enables legislators and citizens alike to: (1) understand what we are getting for our money, (2) assess agency and program performance, and (3) improve and ensure greater governmental accountability and transparency. That said, the system cannot--and should not--be used to abdicate the hard policy, budget, and political decisions that we, as public servants, have an obligation to make in the best interest of the public and the taxpayer.

Texas' fiscal accountability system is the foremost system of its type of any state in the U.S. During the past 15 years, 28 delegations of foreign government officials representing 38 countries have travelled to Austin to learn how Texas has integrated strategic planning, performance budgeting, and performance monitoring into a seamless system that promotes statewide accountability, effectiveness, and efficiency—and most importantly—extols the many virtues of budget transparency.

I would be delighted to respond to any questions.

Thank you very much.

Exhibit A

TEXAS STATEWIDE GOVERNMENT ACCOUNTABILITY INITIATIVES

1973	Program Evaluation
1973	Fiscal Note Process
1977	Sunset Review Process
1979	Survey of Organizational Excellence
1991	Texas Performance Review
1991	Performance Budgeting
1991	Strategic Planning
1991	Federal Funds Analysis
1991	School Performance Review
1993	Performance Monitoring
1993	Rewards and Penalties
1995	Performance Benchmarking
1995	Investment Budgeting
1995	Budget Analysis by Service Type
1997	Activity-based Costing
1997	Enhanced Compensation Program
1999	Customer Satisfaction Assessment
1999	Higher Education Performance Reviews
2002	Fiscal Officers' Academy

Exhibit B

TEXAS' STRATEGIC PLANNING, PERFORMANCE BUDGETING, AND PERFORMANCE MONITORING SYSTEM

STRATEGIC PLANNING

- Five-year Strategic Plans
- Internal/External Assessment
- Goals, objectives, and strategies
- Outcome, output, efficiency, and explanatory measures

PERFORMANCE BUDGETING

- Appropriations by goals and strategies
- Outcome, output, efficiency, and explanatory measures, and targets
- Object-of-expense informational listing

PERFORMANCE MONITORING

- Quarterly reporting
- Measure audit and certification
- Annual budget and performance assessments

PERFORMANCE REWARDS AND PENALTIES

- Discretionary use by Legislature
- Use of enhanced compensation

Exhibit C

TEXAS' STRATEGIC PLANNING, PERFORMANCE BUDGETING, COMPONENTS, AND PERFORMANCE MONITORING TEMPLATE

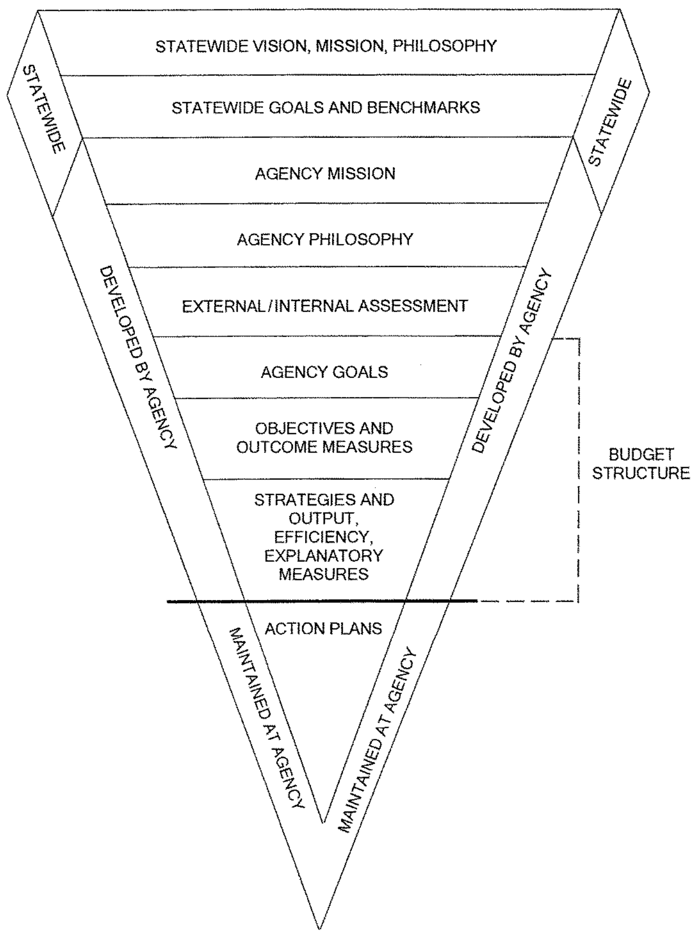

Exhibit D

EXAMPLE OF PERFORMANCE BUDGETING

TEXAS DEPARTMENT OF HEALTH

	Fiscal Year 2004	Fiscal Year 2005
D. Goal: EQUITABLE ACCESS Work to eliminate disparities in health status among all population groups. Reduce rates of diseases and conditions which disproportionately affect minority populations. Allocate public health resources in a rational and equitable manner.		
Outcome (Results/Impact):		
Number of Infant Deaths Per Thousand Live Births (Infant Mortality Rate)	5.5	5.5
Percentage of Low Birth Weight Births	7.2%	7.1%
Number of Pregnant Females Age 13-19 Per Thousand (Adolescent Pregnancy Rate)	63.5	62.4
D.1.1. Strategy: WOMEN AND CHILDREN'S HEALTH SRVS	$ 47,350,491	$ 47,350,493
Provide easily accessible, quality and community-based maternal and child health services to low-income women, infants, children and adolescents.		
Output (Volume):		
Number of Infants <1 and Children Age 1-20 Years Provided Services by the Maternal and Child Health Program	45,366	45,366
Number of Women Provided Services by the Maternal and Child Health Program	69,538	69,538
D.1.2. Strategy: FAMILY PLANNING	$ 78,565,466	$ 80,980,454
Increase family planning services throughout Texas for adolescents and women.		
Output (Volume):		
Number of Adults and Adolescents Receiving Family Planning Services	464,883	444,260
Efficiencies:		
Average Annual Cost Per Family Planning Client	179.99	192.6
D.1.3. Strategy: SPECIAL NEEDS CHILDREN	$ 37,522,763	$ 37,522,764
Administer the Children with Special Health Care Needs Program.		
Output (Volume):		
Number of Children with Special Health Care Needs - Receiving Case Management Services	31,372	31,372
Explanatory:		
Number of Clients Removed from Waiting List and Provided Services	250	250
D.1.4. Strategy: ABSTINENCE EDUCATION	$ 5,309,110	$ 5,309,110
Increase abstinence education programs in Texas.		
Output (Volume):		
Number of Persons Served in Abstinence Education Programs	288,520	288,520
D.2.1. Strategy: COMMUNITY HEALTH SERVICES	$ 18,483,168	$ 18,483,168
Develop systems of primary and preventive health care delivery to alleviate the lack of health care in underserved areas of Texas; and develop and implement program policies that are sensitive and responsive to minority populations.		
Total, Goal D: EQUITABLE ACCESS	$ 187,230,998	$ 189,645,989

Ms. WATSON. Thank you, Mr. Barton.

Mr. Hettinger, you may proceed, please.

STATEMENT OF MICHAEL HETTINGER

Mr. HETTINGER. Thank you very much. Madam Chair, members of the subcommittee, Mr. Cuellar, thank you very much for the opportunity to testify today. I have a longer written statement which I submitted to the committee, and I would like to have that included in the record, but I will try to summarize those remarks here this morning.

As was previously mentioned, from 2003 to 2006 I served as staff director of this subcommittee, then known as the Subcommittee on Government Management, Finance, and Accountability, then under the leadership of Todd Platts of Pennsylvania. As a result, I know first-hand that the work of this subcommittee is extremely important to the efficient and effective operation of the Federal Government.

Also, as was previously mentioned, I am currently a director with Grant Thornton's global public sector practice, but I am here today as a witness based on my experience in the U.S. Congress, specifically my time on this subcommittee, and my testimony does not necessarily reflect the views of Grant Thornton.

My testimony today is really focused on two areas of specific interest to the subcommittee: Government performance and budgeting, generally, and, second, H.R. 2142, Mr. Cuellar's legislation, known as the Government Efficiency, Effectiveness, and Performance Improvement Act of 2009.

Linking budgets to performance with the expectation of achieving better results is extremely important and something I know this subcommittee has spent a great deal of time focused on. When Congress passed the Government Performance and Results Act [GPRA], in 1993, I believe it envisioned a comprehensive integration of agency annual performance plans with the annual budget process, a worthwhile goal. GPRA also sought a more open, accountable, and transparent Government. As we sit here today, 17 years after GPRA's enactment, I believe we continue to strive to achieve that vision.

GPRA did provide a sound baseline for linking budget and performance. Agency strategic plans as required under GPRA force agencies to think strategically about the implementation of their budgets and how those budget expenditures achieve results. I believe we have seen significant improvement as a result of GPRA.

Building on GPRA and prior management improvement efforts, such as President Clinton's reinventing Government, the Bush administration implemented the President's management agenda to drive agencies to better performance and results. The PMA also implemented a management tool known as the Program Assessment Rating Tool [PART]. PART, as I am sure the committee members know, over the 8 years of the Bush administration reviewed the performance of all programs 20 percent a year over a 5-year period, utilizing a simple questionnaire, and then making that information available to the general public via RESULTS.GOV. This effort, while well intentioned, was not without controversy, both at the agency level and here in Congress, in large part due to the fact that the effort was driven by OMB, as opposed to the Congress or the individual agencies. In addition, many stakeholders felt the reviews were being used for political purposes.

This brings me to my discussion of Representative Cuellar's legislation, H.R. 2142, the Government Efficiency, Effectiveness, and Performance Improvement Act of 2009. This legislation is very similar to legislation that Representative Platts and I developed in 2004 known as the Program Assessment and Results Act [PAR], reported out of this committee in the 108th Congress. Like Representative Cuellar's bill, this legislation sought to ensure the periodic review of Government programs to measure their efficiency and effectiveness.

In addition to the basic requirement of this legislation that all Federal programs be reviewed at least once every 5 years, H.R. 2142 includes a number of other key provisions that I believe are essential should this bill move forward. These include, first, providing for advanced publication of the list of programs to be reviewed. Second, requiring the development of a process to receive stakeholder comment. Third, requiring the reporting of the results of the program assessments through the annual budget process. And last, requiring the development of an improvement plan to address weaknesses identified through these reviews.

The bill also designates the agency performance improvement officer as the key official responsible for program assessment and review, a position, I would add, that did not exist when Representative Platts' legislation was introduced.

I wanted to share with the committee today some of the important lessons I learned through the effort to move Representative Platts' legislation through this committee. First and foremost, let me say I believe the concept of reviewing Federal programs for effectiveness on a regular basis is a good idea. It is only through this type of effort that we are able to determine if the programs are achieving the results we desire.

As you consider H.R. 2142, I encourage you to look to the following issues that were raised by various stakeholders during consideration of Representative Platt's legislation.

First, congressional intent must be an overriding consideration when determining the effectiveness of a program. In the vast majority of cases, there is a legislative underpinning to a Federal program, and, while that program may have changed or evolved over time, the intent of Congress when that legislation was passed or the express congressional content as the program evolved must be a strong factor in determining its effectiveness. I encourage the committee when looking at this legislation to work with their counterparts on the Appropriations Committee, as well as the Authorization Committees of jurisdiction and obtain their input on the bill.

Second, reviews must be empirical, fact-based, and made without political judgment.

Third, the metrics used to assess the effectiveness must match the intent of the program, i.e., there must be agreement in advance on what outcome the program was intended to achieve, and it must be judged against that intended outcome.

Fourth, some results are subjective and therefore it is more difficult to assess the effectiveness of certain programs than others.

Fifth, any effort to review program effectiveness must be driven at the agency level rather than dictated from OMB. OMB should, however, play an active advisory role in the process.

Last, common sense must prevail.

I applaud the committee for its ongoing efforts to improve the transparency, efficiency, and effectiveness of the Federal Government. The more transparent our Government is, the more I believe the citizens of this country will be able to trust that their hard-earned tax dollars are being used in a way that achieves results.

I also applaud Representative Cuellar for his ongoing efforts to enhance the legislative debate that Chairman Platts started 5 years ago regarding the need to review the effectiveness of Government programs on a recurring basis.

Thank you again for the opportunity to appear before the subcommittee today. I would be happy to answer any questions.

[The prepared statement of Mr. Hettinger follows:]

Testimony of Michael Hettinger

before the Subcommittee on Government Management, Organization and Procurement

Committee on Oversight and Government Reform

U.S. House of Representatives

April 14, 2010

Madam Chair and Members of the Subcommittee, thank you for the opportunity to testify today. It is an honor to appear before the Subcommittee.

From 2003 – 2006, I served as Staff Director of this Subcommittee, then known as the Subcommittee on Government Management, Finance and Accountability, under the leadership of Chairman Todd Platts of Pennsylvania. I know first-hand that the work of this Subcommittee is extremely important to the efficient and effective operation of the federal government.

I am currently a Director with Grant Thornton's Global Public Sector practice, but I am here as a witness today based on my experience in the U.S. Congress, specifically my time on this Subcommittee, as well as nearly a decade focused on issues affecting government performance, efficiency, and effectiveness. My testimony does not necessarily reflect the views of Grant Thornton LLP.

As requested in the letter of invitation, my testimony is focused on two areas of specific interest to the Subcommittee --(i) government performance and budgeting generally and (ii) H.R. 2142, the Government Efficiency, Effectiveness, and Performance Improvement Act of 2009.

GPRA set the stage for a results-oriented government

Linking budgets to performance with the expectation of achieving better results is extremely important and something I know this Subcommittee has spent a great deal of time focusing on. When Congress passed the Government Performance and Results Act (GPRA) in 1993, it envisioned a comprehensive integration of agency annual performance plans with the annual budget process --a worthwhile goal. In 1993, GPRA offered a management vision of the future -- of a government where the effectiveness of government programs would be measured by actual results. GPRA also sought a more open, accountable and transparent government. As we sit here today, 17 years after GPRA's enactment, I believe we continue to strive to achieve that vision.

With the passage of the American Recovery and Reinvestment Act of 2009, Congress and the Obama Administration continued the push for a more open and transparent government. What that means and how we define transparency continues to be debated. In order to improve citizens' trust in government, information must be presented in a useful and understandable manner.

GPRA provided a sound baseline for linking budget and performance. Agency strategic plans as required under GPRA, along with annual performance plans, force agencies to think strategically about the implementation of their budgets and how those budget expenditures achieve results. We have seen significant improvement as a result of GPRA, as well as annual agency Performance and Accountability Reports (PARs) and annual financial statements as required by the Chief Financial Officers Act.

When I served as Staff Director of this Subcommittee I had the opportunity to speak to many groups interested in government performance. One of the areas on which I consistently focused was the need to recognize what I called the "two budget processes", those being, first, the process by which an agency works with the Office of Management and Budget (OMB) to formulate their annual budget request and, second the annual Congressional appropriations process which puts funding behind those budget initiatives. These two processes are in many ways linked very closely, but in other ways are two very separate and distinct efforts. GPRA is primarily a strategic part of the first process, and I believe the agency-produced GPRA strategic and annual performance plans greatly influence the development of OMB's budget submission to the Congress. With regard to the second process, because of timing and the very nature of the appropriations process, I do not believe the GPRA plans have the same influence on Congress's efforts. More needs to be done if there is a desire on the part of this Committee or others in the Congress to utilize GPRA or the PARs to influence the appropriations process.

Bush Administration's PMA

Building on GPRA and prior management improvement efforts, such as President Clinton's *Reinventing Government*, the Bush Administration implemented the *President's Management Agenda (PMA)* to drive agencies to better performance and results. The PMA took an overall view of improved management and focused on linking budget to performance and results, as well as such key areas as financial performance, human capital management and expanded electronic government. This effort was largely successful in making agencies pay more attention to the performance of their programs, and it improved the overall efficiency of government. We still have a long way to go.

The PMA also implemented a management tool, known as the Program Assessment Rating Tool or PART. PART, over the 8 years of the Bush Administration, reviewed the performance of all government programs, 20% of all programs per year over a 5-year period, utilizing a simple questionnaire and then making that information available to the general public via Results.gov. This effort, while well-intentioned was not without controversy both at the agency level and here in Congress, in large part due to the fact that the effort was driven by OMB, as opposed to Congress or the individual agencies, as required under GPRA. In addition, many stakeholders felt that the reviews were being used for political purposes.

H.R. 2142, the Government Efficiency, Effectiveness and Performance Improvement Act of 2009

This brings me to my discussion of Representative Cuellar's legislation, H.R. 2142 the Government Efficiency, Effectiveness and Performance Improvement Act of 2009. This legislation is very similar to legislation that Representative Platts and I developed in 2004, known as the Program Assessment and Results Act or PAR Act, introduced as H.R 3826 in the 108th Congress and H.R. 185 in the 109th Congress. Like Representative Cuellar's bill, this legislation sought to ensure the periodic review of government programs to measure their efficiency and effectiveness. H.R. 3826 was reported by the full Government Reform Committee but never considered by the House.

In addition to the basic requirement of this legislation that all federal programs be reviewed at least once every five years, H.R. 2142 includes a number of other key provisions that I believe are essential should this bill move forward. These include:

1. Providing for advance publication of the list of programs to be reviewed;
2. Requiring the development of a process to receive stakeholder comment;
3. Requiring the reporting of the results of the program assessments through the annual budget submission; and
4. Requiring the development of an improvement plan to address weaknesses identified through these reviews.

The bill also designates the agency Performance Improvement Officer as the key official responsible for program assessment and review – a position that did not exist when Representative Platts's legislation was introduced.

Lessons Learned

I would like to share with the Subcommittee today the important lessons I learned from the effort to move Representative Platts's legislation through this Committee. First and foremost, I continue to believe that the concept of reviewing federal programs for effectiveness on a regular basis is a good idea. It is only through this type of effort that we are able to determine if the programs are achieving the results we desire.

As you consider H.R. 2142, I encourage you to consider the following issues that were raised by various stakeholders during the consideration of Representative Platts's legislation in the 108th and 109th Congresses:

1. Congressional intent must be an overriding consideration when determining the effectiveness of a program. In the vast majority of cases, there is a legislative underpinning to a federal program, and while that program may have changed and evolved over time, the intent of Congress when that legislation was passed and expressed Congressional intent as the program evolved, must be a strong factor in determining effectiveness. I encourage the Committee, when looking at this legislation, to work with your counterparts on the appropriations committee and authorization committees of jurisdiction to obtain their input on the bill.
2. Reviews must be empirical, fact-based and made without political judgment.
3. Metrics used to assess effectiveness must match the intent of the program, i.e. there must be agreement in advance on what outcome the program was intended to achieve, and it must be judged against that intended outcome.
4. Some "results" are subjective, and, therefore, it is more difficult to assess the effectiveness of certain types of programs than others. For example, a program designed to increase high school graduation rates can easily be measured by comparing the dollars invested to the direct increase in graduation rates, while a program designed simply to "improve the environment" requires a more subjective review because its results are not necessarily evident at a specific point in time.

5. Any effort to review program effectiveness must be driven at the agency level, rather than dictated from OMB. Since no one understands these programs better than the government employees implementing them on a day-to-day basis, I believe they are best positioned to drive these reviews. OMB should, however, play an active, advisory role in the review process.
6. Lastly, common sense must prevail.

I applaud the Committee for its ongoing efforts to improve the transparency, efficiency and effectiveness of the federal government. The more transparent our government is, the more I believe the citizens of this country will be able to trust that their hard-earned tax dollars are being used in a way that achieves results. I also applaud Representative Cuellar for his ongoing efforts to enhance the legislative debate that Representative Platts started 5 years ago regarding the need to review the effectiveness of government programs on a recurring basis.

Thank you again for the opportunity to appear before the Subcommittee today and I am happy to answer any questions the committee members may have.

Ms. WATSON. Thank you.
Now Ms. de Rugy.

STATEMENT OF VERONIQUE DE RUGY

Ms. DE RUGY. Good morning, Chairwoman Watson and members of this subcommittee. It is an honor to appear before you today to discuss the financial situation of the U.S. Government.

My name is Veronique de Rugy. I am a senior research fellow at the Mercatus Center at George Mason University, a research based organization where I study budget and tax issues. It is in this capacity that I have studied and reported on America's fiscal situation for a number of years.

As GAO has noticed, America's financial situation is unsustainable. In 2009, the Federal Government ran a $1.4 trillion deficit. That reports 10 percent of GDP, a level unseen since the second World War. More worrisome, the CBO projects that without policy changes, we will be running annual average deficit of $1 trillion during the next 10 years.

Also, as our Nation's two most expensive programs, Medicare and Social Security, continue to grow, the trust fund of these programs will run larger cash-flow deficits. Over the next 75 years, the Government has promised benefits for these two programs in excess of anticipated payroll tax revenues equal to $7.7 trillion and $38 trillion respectively. The Treasury Department estimates that tax would have to rise by about one-third to pay all the promises that have been made for these two programs, alone, and OMB estimates that in the absence of massive cuts in Social Security, Medicare, and other programs, or an equivalent massive tax increase, the national debt will rise to 77 percent of GDP in 2020, 100 percent in GDP in 2030, and more than twice GDP in 2050.

You have heard from other witnesses about the Federal Government's financial situation, so I will shift gears and focus the rest of my remarks on two points: first, deficits and debt matters; second, the accounting practices and methods used by the Federal Government underestimate the gravity of our situation.

First, some commentator on both sides of the aisles continue to insist this deficit and debt do not matter much. It is important to understand why they are mistaken. My written testimony details six reasons why deficit and debt matter, but I will focus on three here.

First, debt is expensive, and the more that we borrow, the higher the cost of borrowing. This year, alone, the Federal Government will pay $700 billion in interest. That is the equivalent of the money we spent on two wards and the entire budget of the Defense Department.

Second, large and unsustained deficit and debt cripple economic growth. Americans simply do not save enough to both lend the Government everything it needs to finance persistent deficit and continue to invest in the growth of the private sector. This means that every dollar that the Government borrows makes it harder for the private sector to borrow an extra dollar it needs to invest in the economy. This hinders economic growth.

Third, a growing debt sends signals to investors that we are becoming risky borrowers. Over the last 2 years, the United States had become increasingly reliant on short-term debt, which makes sense in time of very low interest rates; however, in the long run, our lenders might reassess the credit risks that the Government represents and start applying rates to reflect that risk, or simply might be less willing to lend us money. When that time comes, access to capital will become harder for everyone. It will be more expensive to buy a house, to fund a business, or to save for the future.

To conclude on this point, running deficits can certainly be appropriate at times of particular stress, such as wars and recession, but in the long run persistent large deficits and growing debt undermine our Nation's prosperity.

My final point deals with the way that the Federal Government accounts for its financial. One of the most compelling examples of this misrepresentation is seen as how the Federal Government accounts for IOUs in the Social Security trust fund. This is on top of everything GAO has mentioned today.

While the Department of Treasury's financial statement of the United States depicts the financial situation of the country much more accurately than the budget of the United States, as it uses accrual accounting rather than cash-flow, it is still deceptive because it leaves out some important elements that hide our true level of debt.

For instance, it does accurately represent some of the Government's unfunded liability, but it also leaves out over $4.4 trillion in intra-governmental debt, $2½ trillion of which is due to Social Security. This is a breach of trust because it fails to inform taxpayers that the same people who already contributed to the trust fund will have to contribute once again once the Government starts repaying its debts to Social Security.

The complex and confusing ways in which the Federal Government goes about accounting for its assets and liability does not allow policymakers and agency decisionmakers to make informed decisions about the Nation's true fiscal position. This needs to change.

I thank you again for the opportunity to testify on this important topic, and I look forward to answering your questions.

[The prepared statement of Ms. de Rugy follows:]

MERCATUS CENTER
GEORGE MASON UNIVERSITY

TESTIMONY

Veronique de Rugy, Senior Research Fellow
Mercatus Center at George Mason University

Before the House Committee on Oversight and Government Reform, Subcommittee on Government Management, Organization, and Procurement Hearing entitled, "Oversight of Federal Financial Management"

10:00 a.m. on Wednesday, April 14, 2010

2247 Rayburn House Office Building

America's financial situation is unsustainable. In 2009 the federal government spent $3.5 trillion but collected only $2.1 trillion in revenue. The result was a $1.4 trillion deficit, up from $458 billion in 2008. That's 10 percent of gross domestic product (GDP), a level unseen since World War II. The Congressional Budget Office (CBO) projects that we will be running large deficits for the foreseeable future. According to its data, the annual deficits could average $1 trillion during the next 10 years.

While these figures are dramatic, they pale in comparison to what the federal government owes to foreign and domestic investors. According to the CBO, in 2009 America's debt held by the public reached $7.5 trillion, or 53 percent of GDP, the highest it has been in 50 years. In 2010 the debt will cross the 60 percent threshold, a level at which many economists believe a country is putting itself in financial peril.

Maybe more importantly, the financial accounting of our financial troubles can lead us to underestimate the gravity of the situation. For instance, while the Department of Treasury's

Financial Statement of the United States depicts the financial situation of the country much more accurately than the Office of Management and Budget's *Budget of the United States*, it leaves out some important elements that could hinder lawmakers' realization of the urgency to address our financial situation. For instance, it accounts accurately for the IOUs in the Social Security Trust Fund, however, fails to account for how the federal government will pay its debt to social security and what it means for our debt levels.

Section 1: Our Financial Situation

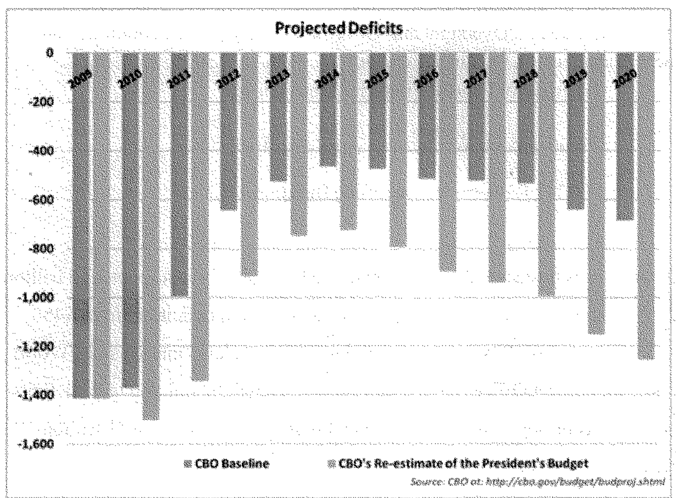

Figure 1: Comparison of the CBO projections of Annual Deficits for the Next Ten Years – Before and After the President's FY 2011 Budget Released.

In 2009 the federal government spent $3.5 trillion but collected only $2.1 trillion in revenues. The result was a $1.4 trillion deficit, up from $458 billion in 2008. That's 10 percent of GDP, a level unseen since World War II. Figure 1 shows that the Congressional Budget Office (CBO) projects that the country will face large deficits for the foreseeable future. They will average $1 trillion annually over the next 10 years.

The situation is deteriorating rapidly. Figure 2 compares the CBO's long-term public debt projections from 2010 with long-term projections calculated in 2007. Three years ago, the CBO projected that the debt held by the public would not surpass 60 percent of GDP until 2023.

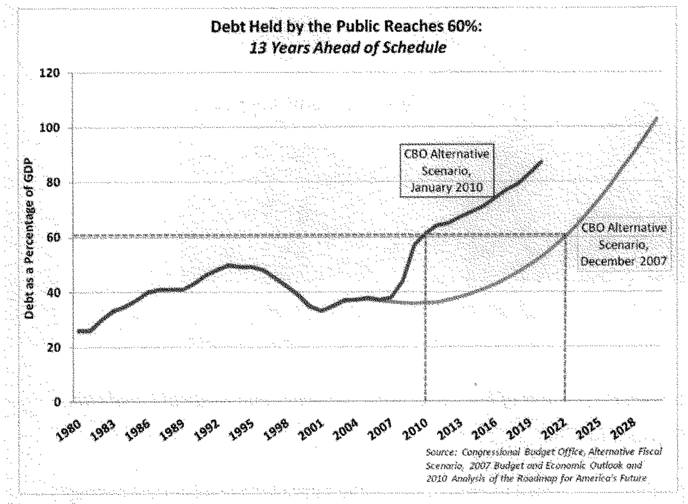

Figure 2: Debt Held by the Public as Projected by CBO in 2007, 2010.

What accounts for our current situation? Deficits and debt are mainly the product of spending. Figure 3 illustrates the Congressional Budget Office's long-term baseline projections of federal spending. Colored segments represent the relative contributions of Medicare and Medicaid, Social Security, and other spending to the overall composition of long-term federal outlays. Importantly, Congressional Budget Office *baseline* projections, which are based on existing law, have been used for this illustration. Projections which incorporate policy changes and likely extensions of existing policy scheduled to expire show even greater long term spending in all areas.

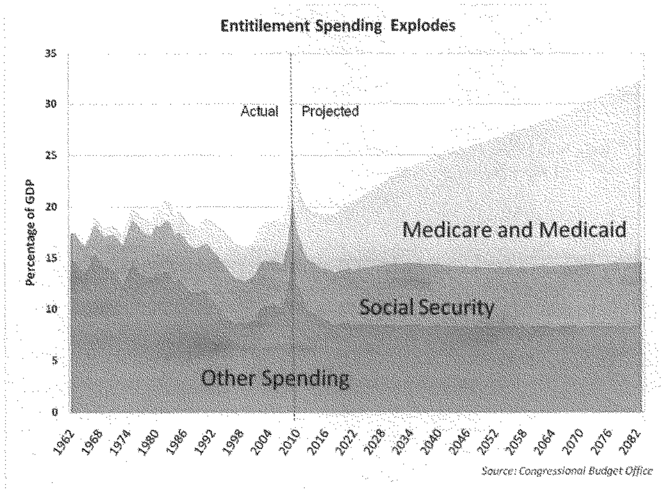

Figure 3: Long-Term Projections of Social Security, Medicare and Medicaid, and Other Spending, as Projected by CBO

Government spending is projected to grow faster in the future than its historical average; entitlement spending is projected to grow substantially faster than future government spending. Over the last 50 years, overall government spending as a percentage of GDP has grown 0.7% annually; in the next 50 years the CBO projects that government spending will grow 30% faster than this historical average. According to CBO's baseline, over the next 50 years, entitlement spending is projected to grow at 1.4% annually, twice the historical rate of increase in government spending.

Medicare spending growth is the primary driver of the explosion in entitlement spending. The President's FY 2011 Budget estimates $451 billion in Medicare spending in FY 2010, a 6% increase in Medicare outlays over 2009, as a percentage of GDP. In the long-term, CBO's baseline projects that Medicare spending will grow by 2.6% annually Moreover, under the CBO's alternative scenario, which includes likely policy changes, Social Security, Medicare and Medicaid and net interest spending combined are projected to exceed *total federal revenue* by 2028.

As entitlement spending increases, the indebtedness of the Medicare and Social Security trust funds Programs will increase as well. Over the next 75 years, the federal government has promised benefits for these two programs in excess of anticipated payroll tax revenues equal to $7.7 trillion and $38 trillion, respectively.

The Treasury Department estimates Social Security's deficit at 1% of GDP over the next 75 years and Medicare's deficit at 4.8%. With federal revenues estimated to be about 19% of GDP in the long run under current law, taxes would have to rise by about one-third to pay all the promises that have been made for just these two programs.

The Office of Management and Budget estimates that in the absence of massive cuts in Social Security, Medicare and other programs, or an equally massive tax increase, the national debt will rise to 77% of GDP in 2020, 100% of GDP in 2030 and more than twice GDP by 2050.

Section 2: Six Reasons Why Deficits and Debt Matter

There are many reasons why these deficits and debt matter. I have listed six of them here:
First, debt is very expensive. Our nation is in debt and faces trillions of dollars in additional projected federal budget deficits over the next decade. The more we borrow, the higher the cost of borrowing. Figure 4 shows the projected interest the government will pay on the federal debt as a percentage of GDP between 1962 and 2082. Based on Congressional Budget Office data, it represents the interest the government paid on the federal debt as a percentage of GDP between 1962 and today and the projected debt service payments up until 2082. The projections are illustrated under the CBO alternative, more realistic, scenario. For comparison, the graph also shows CBO's projections for the cost of Medicare and Social Security as a percentage of GDP. Notice that under either of CBO's scenarios, the net interest payments, or the costs of the debt, rival the cost of two of our nation's most expensive social programs.

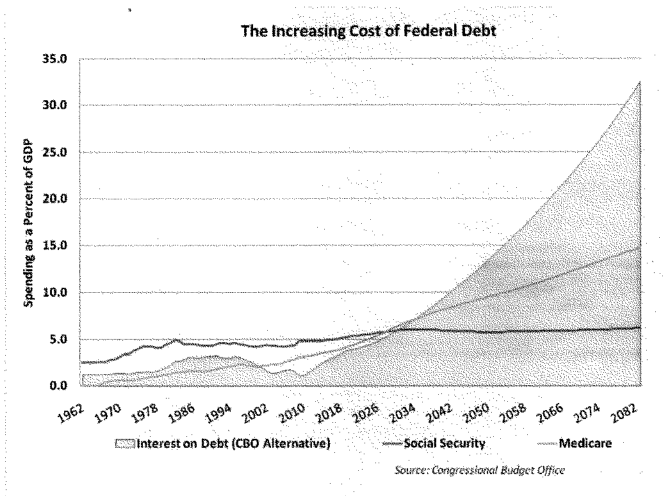

Figure 4: Interest Paid on the Federal Debt Annually, With Annual Spending on Social Security and Medicare, From CBO

Today the United States pays $700 billion to pay interest on our debt. By 2020 the federal government will spend a projected $900 billion. That's more than what the U.S. spends right now on two wars, plus the Departments of Defense, Education, Energy, and Homeland Security combined.

Second, large and sustained deficits and debt inevitably cripple economic growth. The money the federal government borrows and the money that private investors borrow to invest in the private sector's growth both come from Americans' savings. Unfortunately, if the federal government keeps growing its debt and need for borrowed funds there might come a point where there could simply just not be enough savings to satisfy both the private and the public sectors' borrowing needs.

Third, our growing debt means the federal government has to rely increasingly on foreign investors to pay its bills. Figure 5 shows America's debt held by the public divided into domestic and foreign debt.

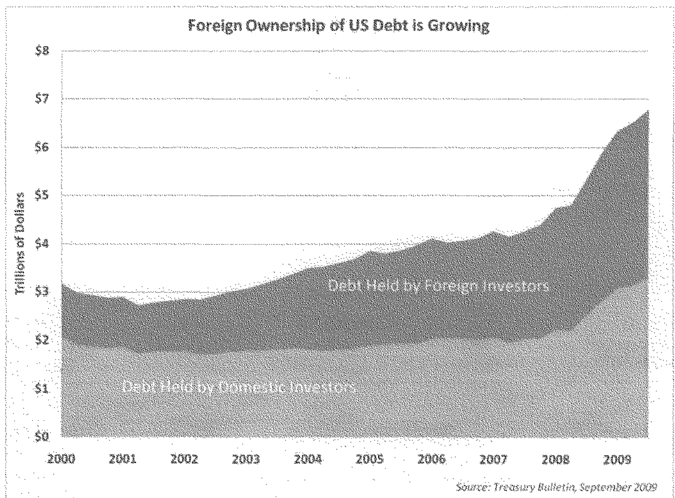

Figure 5: Debt Held by the Public Divided Into Foreign Owned and Domestically Owned Components

This reliance can give significant bargaining power to individual foreign governments, such as China, in their diplomatic negotiations with Washington. According to a recent *National Affairs* article by Donald Marron, an economist at the Georgetown Public Policy Institute, countries such as China and Japan have been the largest buyers of Treasury securities. They believe, Marron writes, "that their willingness to finance our debt gives them leverage in negotiations about other issues, ranging from nuclear proliferation to human rights. Such leverage cannot be beneficial for America's competitive or strategic interests."[1]

Fourth, a growing debt sends signals to investors that we are becoming riskier borrowers. What happens when you max out all your credit cards and still don't have enough money to pay your bills? One thing you could do is get another credit card and roll over the balance. But how long will it be until no one gives you another credit card? How long before your interest rate goes from 12 percent to 30 percent?

This is what the federal government is doing right now. It is constantly rolling over short-term debt. However, there might be a point where our lenders reassess the credit risk that the federal government represents and start applying rates to reflect the risk the government has become. When that time comes access to capital will become harder for everyone. It will be more expensive to buy a house, fund a business, or save for the future.

This development fuels a fifth concern: inflation. To get deficits under control the federal government could cut spending, increase taxes, or do some of both. Neither of these policies is popular; hence the temptation to print money (or "monetize the debt") to pay the bills. The resulting inflation would reduce the value of each dollar, and it would introduce high levels of uncertainty into the economy. Imagine what it would be like to try to calculate the net present value of your investment in an environment where you can't predict what your dollars will be worth tomorrow. Such circumstances mean less innovation and less entrepreneurship, and therefore less economic growth and more hardship.

Marron argues that the Federal Reserve is probably unwilling to take the inflationary route today.[2] But investors know that other central banks have done so in the past and that such a scenario could happen again. In exchange for extending more loans to a federal government that has become a riskier borrower, lenders will ask for an inflation premium. American families and businesses will pay those prices, further hindering economic growth.

If these growing deficits aren't addressed immediately, we are about to embark on the most massive transfer of wealth from younger taxpayers to older ones in American history. It will not only be unprecedented but will also be unfair. As economists have noted, if we borrow to make investments—medical research, infrastructure or otherwise—future generations will be able to reap the benefits of these investments. In fact, these benefits might even offset the costs of paying down the debt accumulated to make these investments. However, when the federal government borrows money to pay for its daily consumption, there is no benefit for the future generations.

Section 3: Even Best Accounting Practices Underestimate Our Situation

According to the Government Accountability Office,[3] "Long term, the federal government faces huge structural deficits driven by rising health care costs and demographics. Focused attention from Congress and the administration is needed to address these problems and put the government on a more sustainable path."

Focused attention is required. However, while the GAO report[4] claims that the federal government is able to make a fair representation of Statement of Social Insurance (Social Security and Medicare), I would like to assert that some elements of the report still underestimate the urgency to address our financial situation.

The Treasury's *Financial Statement of the United States* gives us a more complete representation of our financial troubles than the *Budget of the United States* or other Congressional documents, because it includes pension liabilities, intergovernmental lending between Social Security and Medicare accounts. It also provides a statement of liabilities in terms of net present value, which allows us to understand future liabilities in today's context.

The Budget of the United States, for instance, utilizes certain methods that make it hard for taxpayers and lawmakers to have a clear idea of what our financial situation actually looks like. A widely accepted method for instance, consists of keeping spending off of the official federal budget. Some off-budget items, such as the U.S. Postal Service and the Social Security and Medicare trust funds, are off-budget by law. However, lawmakers have also made a habit of keeping other spending items off the record informally. According to the Congressional Budget Office (CBO), the government sponsored enterprises Freddie Mac and Fannie Mae are on track to cost taxpayers $64 billion between 2011 and 2020, on top of the $110 billion in taxpayer money they have already spent. But none of this spending is included in the official budget.

Also, federal employee retirement funds are among the largest off-budget accounts, and the financial commitment they represent is never publicized. If the federal government had accounted, as a private firm would, for its future pension liabilities, there never would have been a budget surplus at the end of the 1990s. What's more, the off-budget game takes advantage of the fact that most government trust accounts bring in more than they spend in the short term, while having substantial unfunded liabilities in the long run.

The use of delayed payments is another common timing trick. Large payments to contractors or vendors due by the end of the fiscal year (September 30) are often paid on October 1—the next fiscal year. That lets Congress "save" money in the current year, though at the cost of having to double up on expenses the year after. This practice of hiding costs one year does not dispense the federal government from paying its debt the following year. However, it will unlikely be prepared to do so.

Another accounting trick is the use of advance appropriation, also called forward funding. This practice provides spending for a future fiscal year without counting it in any year's budget. For the last 20 years, about $20 billion of "forward funding" per year has paid for everything from housing vouchers to education programs such as Head Start. Basically, it means that Congress can in effect accrue the obligation now without having to pay for it in the budget until later. This maneuver allows Congress to spend more than it should under budget rules.

Also, as professor Cherryl D. Block of Washington University of Saint Louis explains in her article *Budget Gimmicks* "these strategies can become addictive. When you put off today's budget spending though an advance appropriations, the budget invoice arrives tomorrow. To make good on the promise to score the budget expenditure against tomorrow's budget means to even further restrict tomorrow's spending."[5]

However, the biggest flaw with the way the *Budget of the United States* accounts for its spending and receipt is by using cash flow accounting rather than accrual accounting. Cash-flow accounting simply records revenue in the fiscal year that they received and expenses in the fiscal year that they are paid. In contrast, accrual accounting records items by income and expenses when the rights to receive and obligations to pay arise, even if no funds were received or paid at that time. Accrual accounting is forward looking and gives a much more accurate idea of our financial situation.

Block notes that "[Accrual accounting] takes into account today the present value of future receipts and subtracts today the present value of future liabilities. Accrual accounting is viewed in the accounting community as so far superior to cash-flow accounting as an accurate measure of financial health and public and private companies are required to use it under generally accepted accounting principles (GAAP) established by the Financial Standards Board (FASB)."[6]

Congress does not hold itself to any formal, defined set of accounting standards and does not require accrual accounting for budget purposes. In fact, both, the Office of Management and Budget and the Congressional Budget Office's bottom line assessments of federal deficits are done using cash-flow accounting.

By these standards the annual *Financial Report of the United States Government* is clearly using superior accounting[7] methodology. This report is prepared by the Department of Treasury and uses accrual accounting. It records today expenses that will occur in the future.

As such, this chart, based on the Treasury' report data, illustrates more accurately our financial position. It compares the year-over-year change in the United States' end-of-year net position. Net position is calculated by netting the government's assets against its liabilities, as recorded in the United States Government Balance Sheet. Just as in the financial statement of a company, this metric provides a general picture of the fiscal situation in the United States. In 2009, the net position of the United States was -$11.5 trillion, a 12% deterioration from 2008.

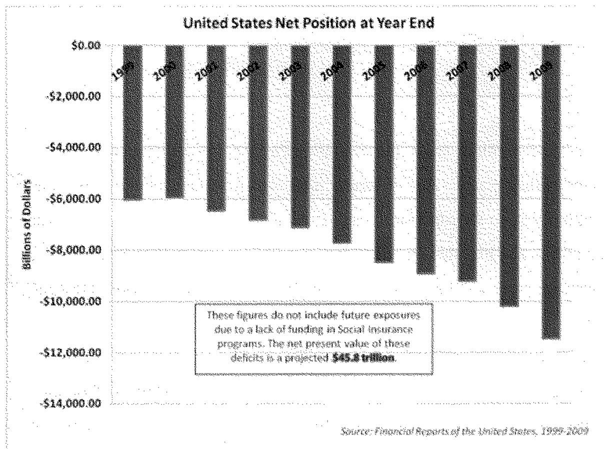

Figure 6: The Net Position of the United States from 1999 to 2009

Net position has been steadily declining since 2000; while the image depicted above is dramatic, the true situation is far worse - exposures for future Medicare and Social Security expenditures are not taken into account in the calculation of net position.

Obviously, the urgency that our nation faces to fix our financial situation is more fully understood when this data is coupled with the data put forward by OMB and CBO about the country's deficits. However, there is another aspect of our financial situation which is being seriously underestimated, even in the Financial Statement of the United States. And that is the projection of our debt held by the public.

As we mentioned earlier, the debt held by the public is the debt that the federal government incurs when it borrows from the public (domestic or foreign) to finance its budget deficits. The debt held by the public totaled approximately $7.6 trillion in FY2009, and was held in Treasury securities, such as bills, notes, and bonds, and accrued interest payable.

As noted in the Financial Statement of the United States[8], "In addition to debt held by the public, the Government has outstanding nearly $4.4 trillion of intragovernmental debt, which arises when one part of the Government borrows from another. It represents debt held by Government funds, including the Social Security ($2.5 trillion) and Medicare ($372 billion) trust funds. These Government funds are typically required to invest any excess annual receipts in Federal debt securities. Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated in the consolidation process for the Government-wide financial statements. When those securities are redeemed, e.g., to pay future Social Security benefits – the Government will need to obtain the resources necessary to reimburse the trust funds."[9] In other words, in order to reduce this intragovernmental debt our debt held by the public will have to grow. Yet, this fact is not obvious to most, and is not reflected in the projections of the debt held by the future.

Let's take the example of the Social Security Trust Fund. The Social Security system is primarily a pay-as-you-go system, meaning that payments to current retirees come from current payments into the system. In the early 1980s, the financial projections of the Social Security Administration indicated near-term revenue from payroll taxes would not be sufficient to fully fund near-term benefits (thus raising the possibility of benefit cuts). The federal government appointed the National Commission on Social Security Reform, headed by Alan Greenspan (who had not yet been named Chairman of the Federal Reserve), to investigate what changes to federal law were necessary to guarantee the fiscal health of the Social Security program.

The changes to federal law enacted in 1983 pursuant to the recommendations of the Greenspan Commission increased the Social Security payroll tax so that revenues derived from the tax would exceed the amounts needed to fully fund current benefits, thus causing a reserve to accumulate, which could be drawn upon when necessary.[10] In theory, the resulting surplus is accounted for in the Social Security Trust Fund.

As of the end of calendar year 2009, the accumulated surplus stood at just over $2.5 trillion. This amount is represented as an asset by many economists. However, unlike a typical private pension plan, the Social Security Trust Fund does not hold any marketable assets to secure workers' paid-in contributions. Instead, it holds non-negotiable United States Treasury bonds and U.S. securities backed "by the full faith and credit of the government".

The Office of Management and Budget has described the distinction between a typical private pension plan and Social Security as follows: "These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures - but only in a bookkeeping sense.... They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits."[11]

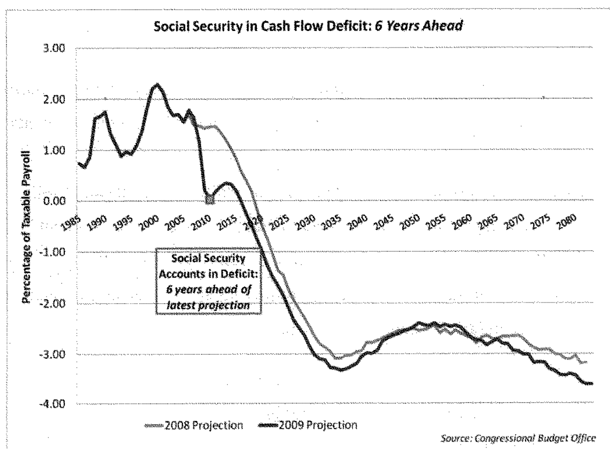

Figure 7: End-of-Year Balance of Social Security Accounts, as Projected in 2008 and 2009

In theory, when social security starts registering a cash deficit (paying out more than it receives in taxes), the shortfall is supposed to be made up by withdrawals from the Trust Fund assets. In addition, in spite of the cash flow deficit, the Trust Fund will continue to show net growth until 2025 because of the interest generated by its bonds.

Also, in theory, the cash flow deficit means that the Trust Fund should gradually be drawn upon to cover the difference between tax receipts and benefit payments. It will be completely depleted by 2037 (according to the Social Security Administration).[12]

The above chart looks at the Social Security trust Fund cash flow surplus and deficit and tracks its evolution. It compares the Congressional Budget Office's (CBO's) projections for the end of year balance of Social Security accounts from 2008 and 2009. These balances are presented as a percentage of taxable payroll, a weighted average of taxable wages and taxable self-employment income which provides an estimate of the earnings subject to payroll taxation each year. For perspective, in 2010 taxable payroll is projected to be $5.6 trillion.

Concretely, when the balance of these accounts becomes negative, Social Security is paying out more in benefits than it collects in payroll taxes in a given year. In 2008, the CBO projected that outlays would exceed revenues for the first time in 2019, and in 2009 CBO projected that this threshold would be crossed in 2016. In reality, Social Security is on track to pay out more in benefits than it collects in 2010. While part of the acceleration in the onset of Social Security deficits is due to the impact of the recession on taxation, by all projections, unsustainable deficits in Social Security accounts will continue into the future.

While this seems to be cause for alarm, not everyone agrees. Some observers argue that the situation is not that bad because in spite of the cash flow deficit, the Trust Fund is really in the black because of interest generated by its bonds. For instance, in a recent article for *Fiscal Times*, Brookings Institution economist Henry Aaron wrote that "Social Security derives revenues from three sources: payroll taxes levied on covered earnings, earmarked income taxes levied on benefits, and interest earnings on reserves. According to the Social Security Trustees' annual report, released in May 2009, revenues from these sources in calendar year 2010 were projected to be, respectively: $701 billion, $26 billion, and $120 billion, for a total of $848 billion. Expenditures were anticipated to be $709 billion."[13]

Aaron, who endorses the data as presented in the *Financial Statement of the United States*, agrees that without the interest payments, the trust fund is running a deficit today.

Sadly, there is a strong case to be made that that the trust fund and the interest payment it receives are simply accounting fiction. The surplus payroll tax revenues that taxpayers have been paying for years to build the trust fund have, in fact, been used and spent by the federal government on other things such as wars, education or homeland security. In other words, the federal government has been using the money to pay for its daily consumption rather than in future investment.

The Trust Fund is made of IOUs from the federal government. Put differently, Social Security is drawing interest from money that was already consumed. To think of an analogy, your bank account credit is lent out to others and stays in your account as an IOU, on which the bank pays you interest. The difference is that a bank lends your money to profit-making enterprises that pay the bank interest, out of which the bank pays your cut.

It is not the case for the federal government, where daily consumption needs to be paid for by borrowing money from the public. Put simply, the federal government pays interest to Social Security by borrowing funds from the public. More importantly, the interest that the federal government owes Social Security are also paid for in the form of IOUs .

The only way Social Security will not go into the red this year is if the federal government borrows money from the public. (See this March's CBO projections here and back out the interest payments to get the true position of the country.) As CBO numbers show, the shortfall this year is $29 billion, or 4 percent of Social Security's budget.[14] The shortfalls get smaller in 2011-13 and turn into small surpluses until things start to go into the red again in 2016, after which the numbers get much worse. A better-than-expected recovery could make these numbers better, but only for a little while.

It is a reality that the Trust Fund and the assets that it owes do not really exist unless the federal government borrows the money or increases taxes. In other words, it is wrong to assume that the trust fund's is made of $2.5 trillion in accumulated assets that can be retrieved easily and that won't be exhausted until 2037.

If the government chooses to increase the tax rates to raise revenue in order to reimburse the Social Security Trust Fund, it will have a serious impact on economic growth. If the federal government chooses to borrow all the money needed to pay back the Social Security Trust Fund as soon as it starts running a cash flow deficit, our financial situation and the fiscal implications for our country will be made worse than what we presented earlier. The chart below illustrates this point.

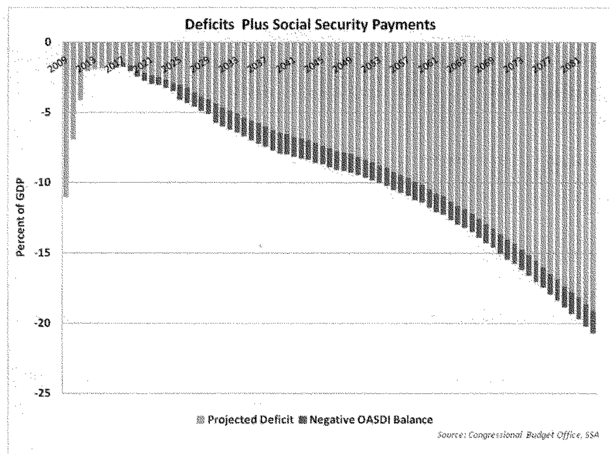

Figure 8: Long-Term Deficit Projections Plus Projected Deficits in Social Security Accounts

Furthermore, since Medicare surpluses have also been re-allocated through intragovernmental lending, it can be shown through analogous arguments that the deficit should be increased even more to reflect reality.

What might happen when the Federal government can't pay back its debt to the Trust Fund? To escape paying either principal or interest on bonds held by the trust funds, the government would have to default on these obligations. An alternative would be for Congress to simply cap Social Security spending at a level below that which would require the bonds to be redeemed. Again, this would be politically risky, but would not require a "default" on the bonds.

Conclusion

As I've shown, the fiscal path of this country is simply unsustainable. The less-than transparent ways in which the federal government goes about accounting for its assets and liabilities does not allow policymakers and agency decision-makers to make informed decisions about the nation's true fiscal position. I thank you again for the opportunity to testify on this most important topic, and look forward to answering your questions.

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[1] Office of Management and Budget at http://budget.gov/budget.

[2] Donald Marron, "America in the Red," *National Affairs*, Issue Number 3, Spring (2010), http://nationalaffairs.com/publications/detail/america-in-the-red.

[3] Donald Marron, Ibid.

[4] Government Accountability Office, *A Citizen's Guide to the 2009 Financial report of the U.S. Government*, (Washington DC, 2010).

[5] Cherryl D. Block (2008), "Budget Gimmicks," In Fiscal Challenges: An Interdisciplinary Approach to Budget Policy, Cambridge University Press, p. 55.

[6] Cherryl D. Block (2008), "Budget Gimmicks," In Fiscal Challenges: An Interdisciplinary Approach to Budget Policy, Cambridge University Press, p. 51.

[7] U.S. Department of the Treasury, *Financial Statement of the United States Government: 2009*, (Washington DC, 2010).

[8] U.S. Department of the Treasury, Ibid.

[9] Government Accounatability Office, Ibid, p 5.

[10] Advisory Council On Social Security, *1996 OASDI Trustees Report: Appendix I*, (Washington DC, 1996), http://www.socialsecurity.gov/history/reports/adcouncil/report/append1.htm.

[11] Office of Management and Budget, *Budget of the United States, FY 2000 Budget, Analytical Perspectives*, p. 337, (Washington DC, 1999).

[12] Social Security Administration, *2009 OASDI Trustees Report*, (Washington DC 2010).

[13] Henry Aaron, "Social Security: Getting the Facts Straight," *The Fiscal Times*, March 28, 2010, http://www.thefiscaltimes.com/Blogs/2010/03/30/~/~/link.aspx?_id=051F8AD4CBFB460CA9299EDA7F214366&_z=z.

[14] Douglas Elmendorf, "Social Security Trust Funds, " *CBO Director's Blog*, March 31, 2010, http://cboblog.cbo.gov/?cat=15.

Ms. WATSON. Thank you so much. I really appropriate the witnesses' input.

Since, Mr. Cuellar, we are really looking at your bill and seeing if it addresses some of the points that were made by our witnesses, I am going to turn the questioning over to you. We only have 5 minutes left for the duration of this committee, and I will yield to you to use those 5 minutes.

Let me just say to the witnesses, too, you need to take into consideration the United States. You need to take into consideration how we make changes and move forward. And you need to take into consideration and suggest to us how we serve.

It was mentioned that our Nation's prosperity, how do we continue to prosper under the current global conditions that are existing today? Do we raise taxes? Do we cut the safety net? What do we do? So we need your guidance. We need your input. That is the reason why we are holding these hearings.

I now yield to Mr. Cuellar.

Mr. CUELLAR. Thank you, Madam Chair. Thank you, again, for allowing this bill to be considered today.

I want to thank all the witnesses for being here. I thank you very much.

If I can just give a quick background, when we talk about results-oriented Government, it is, I think, an idea that both Democrats and Republicans can work on. If I can just give you my personal experience, back in Texas we started in 1991 with Governor Ann Richards, then in 1994 Governor Bush at that time—then, of course, President Bush—came in. One of the concerns I had was you have a shift from a Democrat to a Republican. Are they going to change things? Actually, Governor Bush at that time went on and built on this idea of performance-based budgeting.

In between that in 1993, I guess around that time, under Al Gore, where this got started on this, there was a gentleman by the name of John Sharp and a team of Texans that came up here and basically talked, gave advice and suggestions to the Clinton administration, a lot of it based on what we had done in Texas. Of course, then the present law that we have built on that.

Then, of course, as the witness, Mr. Hettinger, came in when then Governor Bush and then President Bush came in, he then started building up on what was done by President Clinton.

So it is an idea that serves both. It doesn't matter if you are a Democrat or a Republican on this particular issue.

Ms. WATSON. Let me just interrupt you here. We were left with a sizable surplus after the Clinton administration, so that is something that he picked up I think during that time. And now in the last 8 years we have been down like this. I would hope that in these hearings we would try to put our thing—and I understand what you are trying to do, and I quizzed my staff this morning as to what was the real intent. As we look at performance based, we are looking at the efficacy of our policies, what works and what doesn't, so that we can dig ourselves out. It will be, I think, decades before we dig ourselves out and reduce the deficit.

Mr. CUELLAR. Right. Exactly.

Ms. WATSON. We have to find the right thing.

Mr. CUELLAR. Another piece of legislation that got passed already, pay-go, pay-go was in place, pay-go got expired in 2003. Two wars got started. Part D Medicare came in and put in a credit card, and then we saw what happened to the surplus on that. That is the pay-go part of it. Today I am talking about results-oriented Government, which basically means if you put one dollar in you want to know what you get for that dollar. This is the effort of this.

As you know, under the Blue Dove Coalition, this is one of the 15 measures that coalition is pushing. In fact, some of the Members over here a while ago are all cosponsors of this legislation.

The effort of this is just basically we want to know if we put in one dollar what are we getting for this dollar. I know that when I served on the Budget Committee we asked some of the agencies do we really know what we are getting out of this, and the experts came in and told us at that time no we don't, we really don't know what we are doing in a lot of the efforts that we are doing.

Basically, if I can just show you what we are trying to do, if we can move the performance based budgeting, basically what gets measured gets done. If we don't know how we are spending our dollars, then we certainly have a problem with that.

Moving on, let me give you a bill pattern. I think this is very important. As an example, in Texas in the 1970's, early 1970's, we basically had line items. This is a line item. Basically, you can see even in the budget you had seasonal help. It was just line items. We are spending this money here on this and this.

Then we moved into the next one into the 1980's and you go more into program spending. If you look at our budget right now, Madam Chair, we basically in the U.S. Congress have a program type of spending, combined with a line item also on that.

If you look into the 1990's—and I think Mr. Barton in your testimony you had something that went a little bit more into—I think it is a little bit more up there than what I have here, but then you go into measures. If you put in $1,000, what do you get for the $1,000. This is what we are trying to get the Federal Government, because I think our Federal Government's budget is so stuck in the almost 1970's, 1980's type of budgeting part of it.

My question, Madam Chair and Mr. Barton, if you can address this, in the early 1990's Texas was also in a deficit, very severe type of situation, so we had come in. We are facing the same type of situation, and I think we are in the perfect time, Madam Chair, to say we are concerned about spending, we are concerned about how we are spending the money. Are we getting the best bang for the dollar? What do we need to do? And I will ask Mr. Barton and Mr. Hettinger, because, as you know, both of you under Mr. Platt had similar legislation. We added some changes, of course, but I want to see if you all can address in a deficit type of situation how can this bill help.

Mr. BARTON. In 1991 we had a $6 billion budget deficit. The leadership wanted to pass a $3 billion tax bill, and directed the Legislative Budget Board and the Texas performance review to come up with $3 billion in cost savings. That review process took 5 months, involved 120 staff from not only State government but the private sector, and we were able to produce $3 billion in savings.

One of the fundamental questions we asked ourselves is whether or not various State programs were worthwhile. We talk a lot about efficiency and effectiveness, but we often don't talk about whether or not the program is worthwhile to begin with. That was one of the questions we asked ourselves in 1991.

Subsequent to 1991, we incorporated these review processes on an ongoing basis. In Texas we have a sunset commission that reviews every agency top to bottom once every 12 years.

Mr. CUELLAR. That was in 1991. That was under Democratic Governor Ann Richards, Democratically controlled State Senate and House Members on that, before Bush comes in in 1995—or 1991, I am sorry. Go ahead.

Mr. BARTON. Yes. So we have a once every 12 year sunset review process that reauthorizes State agencies and looks at whether or not programs are worthwhile, agencies are worthwhile, as well as whether or not they are efficient and effective.

We also have an ongoing biennial review of various State programs. The Legislative Budget Board produces on a biennial basis between 70 and 100 separate reports on any number of the State's 2,000 programs that receive State appropriations.

And then, in addition, we do have a process that involves the State auditor's office, looking at the financial accountability aspects of agency expenditures.

All told, I think we have a fairly robust system of fiscal accountability that allows us to not again only look at the efficiency and effectiveness of programs, but the question as to whether or not they are worthwhile and the extent to which we can use cost/benefit analysis in the appropriations process.

Mr. HETTINGER. Just to add a little bit to those comments and maybe spin it back to the idea of how this actually helps us to manage the deficit, I think from my perspective this is one piece. Program assessment and review is one piece of a larger financial picture. If you look at what has been done traditionally with the program assessments and the recommendations that have come as a part of the budget as a result of those program assessments, I would venture a guess to say that 75 to 80 percent of the recommended cuts, based on whether they be PART reviews or other program assessments, Congress has chosen to fund. So that is an issue that you need to look at.

I had in my broader statement a discussion of sort of my thinking around what I call two budget processes, one being the process of agencies working with OMB on the development of their budget, and then the second piece of that being the agency work with their appropriators to actually put funding behind those programs. They are really two separate pieces, and when you are talking about program assessments, at least as they have traditionally been done, those are done in the first part, which is the agency working with OMB. That is why I think it is important as you look at this legislation that you get the buy-in from the appropriators.

I will say, if we could have gotten buy-in 4 or 5 years ago from the appropriators, we probably would have been able to enact that legislation that Chairman Platts had introduced, but we didn't get that buy-in, and so I think that is a really important piece that you need to look at going forward. We can talk here or I can share some stories with you offline. I mean, we met with the appropriators, we talked a lot about this.

One of the issues, and I didn't address this in my testimony and I am not sure how it is addressed in your legislation, but the PART system as President Bush implemented it has a score. It says effective, ineffective, results not demonstrated, etc., but it also gives it a score, a numeric score, 75, 80, 100, whatever it may be, or in some cases a 25. And if you look at it from the perspective of the Appropriations Committee, if I fund a program that got a 25 and that is a transparent process, you actually put yourself in a somewhat awkward situation because you are essentially asking them to fund what has been termed an ineffective program.

Again, the score is an issue that I think folks need to look at.

I will stop with that, but I do think, as I said, it is one piece. It can certainly help the deficit reduction, but Congress needs to play a part in that, too.

Ms. DE RUGY. Can I add something. The Mercatus Center has done a lot of work on performance based management and transparency, and there is actually a very large economic literature on the topic. Really the main conclusion is that unless there is accountability and a bill or this type of performance based budgeting has real teeth in actually holding people accountable and effectively cutting spending, it is just not working. It is like with transparency, transparency is certainly a necessary piece of the process, but it really isn't sufficient. You need to have both things together.

So it is a first very good step in that direction, but it won't be performing effectively, especially I mean like the difference I think between State budgeting and Federal budgeting is that in theory the State governments are not allowed to run deficits, so they are put in a situation where they have to do something. I will grant you that a lot of the things they do is use gimmicks to actually make it look as if their budget is balanced, and in that sense I actually think that their performance based budgeting can help. But the Federal Government doesn't have this obligation, and, as you have used the term putting it on the credit card, you are absolutely correct.

As the Chairwoman noted, while there has been, for about 17 or 20 years, a lot of talk about transparency, a lot of talk about looking at performance of programs, yet we have managed to go from a situation of surplus to a situation of deficit, and gigantic deficit.

I think in order for any bill to include the full process, it needs to have the transparency aspect, but also the accountability that goes with it. That is key.

Mr. CUELLAR. Thank you.

Ms. WATSON. We are out of time.

Let me just say this: I feel that your bill will help us in terms of what works in terms of program. When you get Executive orders, we went into a war and spent $15 billion a month. That is going to affect the bottom line. The appropriators have nothing to do with that, and I am hearing the witnesses saying this ought to be an issue that the appropriators listen to, so we have to unscramble some rotten eggs.

I do thank you for the point you are raising, because we are going to have to look at each sector of government. We are the Federal Government. What happens in the States? And then what happens in local government? And so this whole apparatus needs looking at, but you give us a way to start looking to see what does work. I hope we can build on what you are putting out there. We certainly are going to have a series of these hearings so that we can look at new directions for operating a country like ours.

We are not isolated. We are impacted with what is happening with the rest of the world. China, with 1.3 billion people, is looming to become a nation in just a matter of a decade or so that is going to be handling the finances for the entire globe, it appears. So we have many different issues to look at with this, and I do thank you for coming and for sharing with us. We will call you back again.

With that, we are going to adjourn this committee meeting. Thank you so much.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned.]

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