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Union Calendar No. 480

107TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
107–765

THE FEDERAL GOVERNMENT'S CONTINUING EFFORTS TO IMPROVE FINANCIAL MANAGEMENT

FOURTH REPORT

BY THE

COMMITTEE ON GOVERNMENT REFORM



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OCTOBER 24, 2002.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE

82–176 PDF WASHINGTON : 2002

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, October 24, 2002.

Hon. J. DENNIS HASTERT,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Reform, I submit herewith the committee's fourth report to the 107th Congress. The committee's report is based on a study conducted by its Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations.

DAN BURTON,
Chairman.

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THE FEDERAL GOVERNMENT'S CONTINUING EFFORTS TO IMPROVE FINANCIAL MANAGEMENT

OCTOBER 24, 2002.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BURTON, from the Committee on Government Reform submitted the following

FOURTH REPORT

On October 9, 2002, the Committee on Government Reform approved and adopted a report entitled "The Federal Government's Continuing Efforts to Improve Financial Management." The chairman was directed to transmit a copy to the Speaker of the House.

I. OVERVIEW

The Federal Government faces pervasive financial management weaknesses that have persisted for decades. The Government as a whole and some of its largest individual agencies cannot balance their books. Few agencies have the financial systems they need to produce timely and reliable data for day-to-day management of their operations. Even fewer agencies can use their financial systems to monitor and make informed decisions about the performance of their programs. Most agencies cannot determine the full costs of their programs much less evaluate their cost-effectiveness.

Not surprisingly, these financial management weaknesses exact a heavy toll on the Government and its citizens. Countless billions of taxpayer dollars are spent improperly each year due to fraud, waste and mismanagement. No one knows exactly how many tax dollars are misspent because the Federal Government makes no systematic and comprehensive effort to keep track of improper payments.

The subcommittee has examined the Federal Government's financial management problems through numerous hearings and other oversight activities. To cite a few examples:

- Each year, the subcommittee issues a financial management "report card" that grades the Federal Government as a whole and each of the 24 major agencies. This year, the Government earned an overall grade of "D" for its financial management in fiscal year 2001—down from a "C-" the previous year. Sixteen of the 24 agencies also received lower grades than in the prior year. Several agencies fell dramatically. The subcommittee applied more rigorous grading criteria this year than in the past. However, some agencies would have received the same low grades even under the more lenient criteria used in prior years.
- Most agencies cannot adequately track and collect debts that are legitimately owed to the Federal Government. Poor debt collection costs the Government billions of dollars in lost revenues and cheats the vast majority of citizens and businesses who meet their obligations to the Federal Government.
- Many Federal agencies fail to control the use of Government purchase and travel cards issued to their employees. The lack of controls have resulted in wasteful and abusive practices at the Department of Defense and many other agencies.
- The Defense Department has made hundreds of millions of dollars in illegal and improper "adjustments" to its appropriation accounts. These adjustments occurred because of the department's excessively complicated financial systems and the lack of basic internal controls.

Similar to the subcommittee's work, the General Accounting Office [GAO] and agency Inspectors General consistently document Federal financial management problems. Every 2 years, the GAO issues a "high-risk list" of those Federal programs and activities that are most vulnerable to fraud, waste and abuse. Of the 23 items on the GAO's current high-risk list, four deal entirely with financial management problems and at least 10 others result, in part, from financial management weaknesses. The Inspectors General for the major Federal agencies also issue an annual "top 10 list" of the most serious problems facing their agencies. Twenty-three of the 26 Inspectors General reporting this year included financial management on their top 10 list.

Congress has enacted a framework of laws to resolve the Federal Government's pervasive financial management problems. However, progress in implementing those laws has been slow and uneven.

All 24 major Federal agencies are now submitting timely annual audited financial statements, in compliance with the Chief Financial Officers Act and related laws. Most agencies are getting "unqualified" (or "clean") opinions on their financial statements. For fiscal year 2001, 18 of the 24 agencies received clean audit opinions. In fiscal year 1996, the first year that audited financial statements were required, only 6 of the 24 agencies received clean opinions.

Despite that improvement, there is much room for improvement. The Federal Government as a whole still cannot pass its annual audit, primarily due to the abysmal state of financial management at the Department of Defense, which consistently receives "disclaimer" opinions. Until the Defense Department gets its financial house in order, the Government as a whole will continue to fail its annual audit. Furthermore, the annual audits disclose that many

agency financial systems still suffer from serious internal control weaknesses and often fail to comply with applicable laws and regulations.

A "clean" audit opinion does not necessarily mean that an agency has good financial management systems. In fact, a clean opinion may even be misleading. That can occur because some agencies achieve clean opinions by working around their financial systems, rather than by relying on them. To achieve the ultimate goal of good financial management, Federal agencies must have financial systems that produce reliable, timely and useful information for day-to-day management and policymaking.

Currently, the best indicator of healthy agency financial systems is whether they comply with the Federal Financial Management Improvement Act. Unfortunately, most do not. According to auditors, 20 of the 24 major agencies failed to comply with the act during fiscal year 2001.

While the Federal Government is years away from operating on a sound financial management footing, the outlook for the future is positive. The President and the Office of Management and Budget [OMB] have demonstrated a genuine commitment toward solving the Federal Government's financial management woes. In August 2001, President Bush issued his "President's Management Agenda," which laid out an ambitious set of priorities to address many of the Federal Government's most chronic management problems. Improved Financial Performance is one of five governmentwide priority initiatives in the President's Management Agenda. This initiative seeks to improve the timeliness and usefulness of financial information. It also seeks to reduce erroneous payments made by Federal agencies.

The OMB developed a management "scorecard" that uses red, yellow and green "traffic lights" to assess Federal agency efforts toward achieving the goals of the President's Management Agenda. The OMB issued baseline evaluations in its scorecard for fiscal year 2001. With respect to financial management, 21 of the 26 agencies evaluated by the OMB received a red light—or unsatisfactory score. Four agencies received a yellow light for mixed results. Only one agency—the National Science Foundation—received a green light for success.

The initial OMB baseline scores are consistent with the subcommittee's findings, as well as the findings of the GAO and Inspectors General. The OMB deserves credit for being candid in its evaluations. The test will be whether the OMB and the agencies follow though in coming years and improve those baseline scores.

Although the Federal Government's financial management problems are deep-seated and severe, they are also solvable. Congressional oversight committees, the GAO and agency Inspectors General have proposed hundreds of specific recommendations for solutions. The administration, the OMB and the agencies themselves clearly recognize the root causes of the problems and their solutions.

The subcommittee offers the following recommendations that focus on how to achieve the specific solutions that are already well documented.

- Above all else, a sustained leadership commitment and persistent follow-up is needed to resolve the Government's financial management problems. Such leadership must come from both the executive branch and Congress.
- Both the administration and Congress must provide the necessary resources to replace or re-engineer dysfunctional financial systems. In most cases, the resource investments that are needed are quite modest in relation to the benefits to be achieved.
- Accountability and incentives to produce results must accompany resources. Agencies should establish results-oriented and measurable performance goals for financial management improvements. The administration and Congress must provide appropriate oversight to ensure that the goals are met.
- Although the basic statutory framework for achieving financial management success is already in place, the enactment of two additional measures would complement the existing framework. H.R. 4878, the "Improper Payments Information Act of 2002," would require agencies to identify systematically areas in which they are vulnerable to making erroneous payments and to report on the steps they are taking to reduce these vulnerabilities. H.R. 4685, the "Accountability of Tax Dollars Act of 2002," would extend to most executive branch agencies the requirement for audited annual financial statements. Currently, that requirement applies only to the Government's 24 largest agencies. Both of these bills should be enacted into law.
- The administration, the OMB and individual agencies need to follow through in implementing the financial management improvement initiatives within the President's Management Agenda. In particular, the OMB needs to follow through on its financial management scorecard by periodically updating its evaluations in an objective and transparent manner. In doing so, the OMB must improve its guidance for evaluating agency compliance with the Federal Financial Management Improvement Act.
- Finally, the GAO, Inspectors General and congressional committees should vigorously pursue their independent auditing and oversight of agencies' efforts to improve their financial management systems and practices. This oversight should include, but not be limited to, an examination of agencies' success in meeting the criteria contained in the President's Management Agenda and the OMB scorecard.

II. INTRODUCTION

The Committee on Government Reform has primary legislative and oversight jurisdiction with respect to "Government management and accounting measures generally," as well as "overall economy, efficiency, and management of Government operations and activities, including Federal procurement." [1] The committee also has the responsibility to determine whether laws and programs addressing subjects within its jurisdiction are being implemented in

[1] Clause 1(h) (4) and (6) of Rule X , Rules of the House of Representatives, 107th Congress.

accordance with the intent of Congress and whether changes to the law are required.[2]

Pursuant to this authority, the Committee on Government Reform's Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations (the "subcommittee") has held numerous oversight hearings and conducted many other oversight initiatives to explore the state of financial management in the Federal Government. This report presents the subcommittee's findings, conclusions and recommendations based on its financial management work over the past year.

III. Findings and Conclusions

A. The Federal Government Suffers From Pervasive Financial Management Problems

Nearly 200 years ago, President Thomas Jefferson recognized the need for effective financial management in the Federal Government:

> I think it an object of great importance . . . to simplify our system of finance, and bring it within the comprehension of every member of Congress . . . the whole system [has been] involved in an impenetrable fog. There is a point . . . on which I should wish to keep my eye . . . a simplification of the form of accounts . . . so as to bring everything to a single centre[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them.[3]

Jefferson's insights are equally relevant today. Sound financial management is essential to ensuring that the trillions of dollars that American taxpayers invest in their Federal Government are used appropriately and wisely. Financial management systems also must be able to produce information that managers and decisionmakers can rely on in order to determine whether Federal programs are achieving the performance results that citizens rightfully expect and demand of them.

Unfortunately, deep-seated and pervasive financial management problems have plagued the Federal Government for many years. Audits consistently show that most agencies have significant weaknesses in their financial management controls and systems. As a result of these weaknesses, billions of taxpayer-provided dollars are lost each year to fraud, waste, misuse and mismanagement in hundreds of Federal programs. Furthermore, Federal decisionmakers do not have reliable, accurate and timely financial and management information to make informed decisions and monitor government performance on a routine basis.

Every 2 years, the GAO issues a "high-risk list" of those Federal programs and activities that are most vulnerable to fraud, waste

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[2] Ibid., Clause 2(b)(1) (A)and (C).

[3] Letter to Secretary of the Treasury Albert Gallatin, Apr. 1, 1802, the Writings of Thomas Jefferson, Edited by Andrew A. Lipscomb (Washington, DC, 1905) Vol. 10, pps. 306–309.

and abuse. Of the 23 items on the GAO's current high-risk list, 4 deal exclusively with financial management problems at the Department of Defense, the Forest Service, the Federal Aviation Administration and the Internal Revenue Service.[4] At least 10 other items on the GAO's current high-risk list result, in part, from financial management weaknesses.[5]

Likewise, the Inspectors General for the major Federal agencies issue an annual "top 10 list" of the most serious problems facing their agencies. Twenty-three of the 26 Inspectors General reporting this year included financial management on their top 10 lists.[6]

Financial management weaknesses exact a heavy toll on the Government and its citizens. Countless billions of taxpayer dollars are spent improperly each year due to fraud, waste and mismanagement. No one knows exactly how many tax dollars are misspent because the Federal Government makes no systematic and comprehensive effort to keep track of improper payments. According to the GAO, the few agencies that voluntarily estimate erroneous payments for a handful of their programs report that such estimates total about $19 to $21 *billion* each year. The figure was $19.1 billion for fiscal year 2001, with fewer agencies volunteering estimates than the year before. In any event, the GAO concluded that the $19.1 billion figure did not present a true picture of the level of improper payments in Federal programs and activities. The GAO report stated:

> As significant as the $19 billion in improper payments is, the actual extent of improper payments governmentwide is unknown, is likely to be billions of dollars more, and will likely grow in the future without concerted and coordinated efforts by agencies, the administration, and the Congress.[7]

Many GAO and Inspector General reports also point to deficient financial management and information systems as a major barrier to the efficient implementation of Federal operations on a day-to-day basis, and to assessing the effectiveness of program performance. Most agencies are unable to use their systems to produce comprehensive and reliable data on the costs of their programs. Some cannot use their systems to reliably determine where or how they are spending their money.

B. A GOOD STATUTORY FRAMEWORK FOR FINANCIAL MANAGEMENT EXISTS, BUT IMPLEMENTATION HAS BEEN SLOW AND UNEVEN

In response to these problems, Congress enacted a series of laws over the past two decades that are designed to improve Federal financial management practices. The Chief Financial Officers Act of

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[4] See High-Risk Update, GAO–01–263 (January 2001), p. 10.

[5] These areas are: Medicare, Supplemental Security Income, Earned Income Credit Noncompliance, Collection of Unpaid Taxes, Defense Department Inventory Management, Housing and Urban Development Department programs, Student Financial Aid, Asset Forfeiture Programs, Defense Department Contract Management, and National Aeronautics and Space Administration Contract Management.

[6] The only major agencies at which financial management was not a top 10 problem area were the Department of Energy, the General Services Administration, and the Social Security Administration.

[7] Financial Management: Coordinated Approach Needed to Address the Government's Improper Payments Problems, GAO–02–749 (August 2002), p. 3.

1990 (CFO Act) (Public Law 101–576) represents the most comprehensive financial management reform legislation over the last 40 years. The CFO Act was amended and expanded by the Government Management Reform Act of 1994 (Public Law 103–356) and the Federal Financial Management Improvement Act of 1996 (Public Law 104–208). Other significant laws affecting Federal financial management include: the Budget and Accounting Procedures Act of 1950 (Chapter 946, 64 stat. 832); the Inspector General Act of 1978, as amended by the Inspector General Act Amendments of 1988 (Public Laws 95–452 and 100–504); the Federal Managers' Financial Integrity Act of 1982 (Public Law 97–255); the Debt Collection Act of 1982, as amended by the Debt Collection Improvement Act of 1996 (Public Laws 97–365 and 104–134, sec. 31001); and the Government Performance and Results Act of 1993 (Public Law 103–62). The key financial management provisions of these laws are summarized in Appendix A of this report.

Audited Financial Statements. The CFO Act, as amended, is intended to provide a more effective, efficient and responsive Government. To that end, it requires 24 Federal departments and agencies to prepare and have audited annual financial statements covering all of their accounts and associated activities.[8] These audited statements are to be sent to the Director of the OMB no later than March 1 of the year following the fiscal year for which the statements are prepared. Next year, the OMB will move up the reporting date from March 1 to February 1. Beginning in fiscal year 2003, the OMB will require agencies to prepare and submit unaudited interim financial statements on a quarterly basis.

Also, the Government Management Reform Act requires that a set of consolidated governmentwide financial statements be prepared by the Secretary of the Treasury in coordination with the Director of the OMB. These consolidated financial statements are to be audited by the Comptroller General of the United States and forwarded to Congress by March 31 of each year. For fiscal year 2004, agencies will be required to produce audited financial statements no later than November 15 and the U.S. Government's audited consolidated financial statements will be due by December 15.

Federal Accounting Standards. Agencies use Federal accounting standards to prepare their financial statements and develop their financial management systems. In October 1990, the Secretary of the Treasury, the Director of the OMB, and the Comptroller General established the Federal Accounting Standards Advisory Board to develop a set of generally accepted accounting standards for the Federal Government. The approved standards are promulgated by the Comptroller General and Director of the OMB. These standards constitute generally accepted accounting principles for the Federal Government. In October 1999, the American Institute of Certified

[8] The 24 Federal agencies covered by the CFO Act include the 14 Cabinet Departments: Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, Housing and Urban Development, Interior, Justice, Labor, State, Transportation, Treasury, and Veterans Affairs. They also include the following 10 independent agencies: the Environmental Protection Agency, the National Aeronautics and Space Administration, the Agency for International Development, the Federal Emergency Management Agency, the General Services Administration, the National Science Foundation, the Nuclear Regulatory Commission, the Office of Personnel Management, the Small Business Administration, and the Social Security Administration.

Public Accountants recognized Federal accounting standards as a generally accepted basis of accounting. This recognition was a major milestone in improving public confidence in the reliability and credibility of Federal financial information.

The Director of the OMB is responsible for setting the form and content of the financial statements against which the auditor must measure an agency's financial statements. The guidance provided by the OMB incorporates the standards recommended by the Federal Accounting Standards Advisory Board.

Financial Management Systems. Financial management systems with well-defined and effective governmentwide functional requirements assist agencies in developing strong systems by eliminating duplicate work among agencies and providing a common framework so that commercial vendors can economically provide systems software. The Joint Financial Management Improvement Program [JFMIP] helps establish uniform requirements as part of a process of improving financial management systems.

Internal Controls. The Federal Managers' Financial Integrity Act and the Federal Financial Management Improvement Act place great emphasis on the importance of effective internal controls. Their importance cannot be overstated in the large, complex operating environment of the executive branch of the Federal Government. Effective internal controls are the first line of defense against fraud, waste and mismanagement of agency budgets. They also help ensure that agencies achieve their missions in the most effective and efficient manner. The subject of internal controls generally surfaces after improprieties or inefficiencies are found. However, good managers continually seek new ways to improve their operations through effective internal controls.

The committee stresses that internal controls can be designed to provide reasonable, not absolute, assurance that an organization's activities are being accomplished in accordance with its objectives. The full cost of fraud, waste, misuse and mismanagement cannot always be known or measured. If improper activities are allowed to continue, public confidence is eroded in the Government's ability to manage its programs effectively or honestly. Such erosion cannot be measured in terms of dollars. The trust of the citizenry in its Government is a priceless relationship.

As discussed hereafter, progress in implementing the financial management reform legislation has been slow and highly uneven. Agencies are doing a much better job of preparing their financial statements on time, and most are now getting unqualified, or clean audit opinions. To meet the ultimate goals of the legislation, however, agencies need to be able to generate timely, accurate and useful financial management information. They also need to have effective internal controls in place to ensure that funds are spent properly and with full and accurate accountability to the American taxpayers. And they must be able to integrate financial and performance data in order to report meaningfully on their performance results, monitor and execute their day-to-day operations, and make informed decisions about the effectiveness of their programs. The Federal Government as a whole and most individual agencies still fall far short of these goals.

C. FISCAL YEAR 2001 FINANCIAL STATEMENT AUDITS SHOW MIXED RESULTS

The fiscal year 2001 annual audited financial statements for the 24 Federal departments and agencies covered by the CFO Act, as amended, were due to be filed with the OMB on February 27, 2002. On March 29, 2002, the GAO issued its fifth annual audit report on the financial statements of the Federal Government. At a subcommittee hearing on April 9, 2002, the Comptroller General of the United States released the fiscal year 2001 audit results.

Similar to last year, 18 of the 24 agencies received unqualified—or clean—audit opinions on their fiscal year 2001 financial statements. In fiscal year 1996, the first year agencies were required to produce audited financial statements, only six agencies received clean opinions. Equally noteworthy, all 24 agencies produced their audited financial statements by the reporting deadline of February 27, 2002. Also, for the first time, agency reports and the governmentwide statements included comparative reporting, which allows the reader to compare the financial information to that of the previous year.

On the other hand, the Federal Government as a whole received a disclaimer audit opinion for the 5th consecutive year. Several major individual agencies—including the Departments of Agriculture and Defense—also received disclaimer opinions. The disclaimer opinion at the Defense Department is particularly significant since it represents the greatest impediment to the Federal Government achieving a clean opinion governmentwide.

The Comptroller General reported that, as has been the case for the past 4 fiscal years—

> a significant number of material weaknesses related to financial systems, fundamental record-keeping and financial reporting, and incomplete documentation continued to (1) hamper the Government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the Government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the Government's ability to adequately safeguard assets and properly record various transactions.[9]

Specifically, the GAO was unable to express an opinion on the reliability of the governmentwide financial statements because of the Federal Government's inability to:

- properly account for and report on billions of dollars worth of property, equipment, materials, supplies and certain stewardship assets, primarily at the Department of Defense;
- use effective processes and procedures to estimate the cost of certain major Federal credit programs and the related loans receivable and loan guarantee liabilities;
- support amounts reported for certain liabilities, such as environmental and disposal liabilities and related costs at the Depart-

[9] "U.S. Government Financial Statements: Fiscal Year 2001 Results Continuing Need to Accelerate Federal Financial Management Reform," GAO–02–599T, Apr. 9, 2002.

ment of Defense, and ensure complete and proper reporting for commitments and contingencies;
- support major portions of the total net cost of Government operations, most notably related to the Department of Defense and the Department of Agriculture, and ensure that all disbursements are properly recorded;
- fully account for and reconcile intra-governmental activity and balances; and
- properly prepare the Federal Government's financial statements, including balancing statements, eliminating substantial amounts of transactions between governmental entities, fully ensuring that the information in the consolidated financial statements is consistent with the underlying agency financial statements, and adequately reconciling the results of operations to budget results.

The GAO's audit report [10] also identified a broad array of financial management problems that limit the Federal Government's ability to safeguard its assets, properly record transactions, and comply with selected provisions of laws and regulations related to financial reporting. According to the GAO, these problems affect the reliability of the governmentwide financial statements as well as the related underlying financial information. More important, the GAO noted these problems "also affect the Government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations." For fiscal year 2001, 21 of the 24 CFO Act agencies were found to have material weaknesses.[11] Furthermore, almost all agencies were reported as having computer security weaknesses. As a result, the Federal Government's financial and other sensitive information is susceptible to inappropriate disclosure, destruction, modification, and fraud.

Noncompliance with applicable requirements in laws and regulations related to financial reporting continues to be a pervasive problem among the 24 agencies. Based on fiscal year 2001 audit reports, only 3 of the 24 agencies were reported to be in compliance with the laws and regulations.

Twenty of the agencies were not compliant with the requirements of the Federal Financial Management Improvement Act of 1996—a key financial management law enacted to ensure that agencies' financial management systems produce timely, accurate and useful financial information. The GAO stated that "noncompliance with FFMIA is indicative of the overall continuing poor condition of many financial management systems across Government." The Comptroller General testified in this regard that agency financial systems overall are in poor condition and cannot provide reliable financial information necessary for managing day-to-day Government operations.

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[10] "Fiscal Year 2001 *Financial Report of the United States Government.*"

[11] A material weakness, as defined by the American Institute of Certified Public Accountants in its *Statements of Auditing Standards* and in the Comptroller General's *Government Auditing Standards,* is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties.

The Comptroller General cautioned that it will be essential for the Government to move away from the extraordinary efforts many agencies now use to attain clean opinions and move toward strengthening their financial systems, reporting and controls. Further, he stated that "many agencies do not have timely, accurate and useful financial information, including cost data, and do not have sound controls with which to make informed decisions and ensure accountability on an ongoing basis." Agencies must have modern financial management systems and effective controls in order to reach the goal of providing the reliable financial information necessary for managing daily Government operations.

D. THE SUBCOMMITTEE'S FINANCIAL MANAGEMENT REPORT CARD SHOWS LOWER GRADES THIS YEAR

In each of the last 4 fiscal years, the subcommittee has issued a financial management "report card" for the Federal Government as a whole and the 24 CFO Act agencies. The report card is a gauge for Congress to determine agencies' progress in improving their financial management.

At its April 9, 2002, hearing on the fiscal year 2001 financial statement audit results, the subcommittee released its fifth annual report card measuring the effectiveness of financial management in the 24 CFO Act agencies. The grades were based on the results of the audit reports prepared by agencies' Inspectors General, independent public accountants, and the U.S. General Accounting Office.

This year, the subcommittee used more rigorous grading criteria than in the past. The purpose of the higher standards was to place less weight on clean audit opinions and to place more weight on whether agency financial systems were actually capable of producing timely, reliable and useful data to support day-to-day operations. Appendix B describes the subcommittee's grading criteria in more detail.

Unfortunately, the grades for fiscal year 2001 were again dominated by "D's" and "F's." As a result, the subcommittee determined that the Federal Government as a whole earned a "D." Sixteen agencies received a lower grade than last year. Most dramatically, the National Aeronautics and Space Administration fell from an "A" to an "F," and the Small Business Administration fell from an "A" to a "D-plus." It is important to note that these two agencies would have suffered the same decline in their grades even under the more lenient criteria that the subcommittee used in prior years.

The failures of a few agencies continue to tarnish the record of the executive branch. For the 5th consecutive year, the Agency for International Development, and two of the Government's largest departments—the Department of Defense and the Department of Agriculture—received the unacceptable grades of "F."

Although 18 agencies received clean audit opinions, significant financial management problems continue to prevent these agencies from achieving the ultimate goal of maintaining financial systems that allow them to produce timely, accurate and reliable financial information on a day-to-day basis.

[The Fiscal Year 2001 Financial Management Status Report follows:]

Fiscal Year 2001 (for the period ended September 30, 2001) Financial Management Status Report			
Federal Departments and Agencies	**Grade**	**Federal Departments and Agencies**	**Grade**
SSA Social Security Administration	B	Commerce Department of Commerce	D-
GSA General Services Administration	B-	Education Department of Education	D-
DOE Department of Energy	C	Treasury Department of the Treasury	D-
OPM Office of Personnel Management	C	NRC Nuclear Regulatory Commission	D-
Labor Department of Labor	C-	Justice Department of Justice	D-
NSF National Science Foundation	C-	State Department of State	D-
EPA Environmental Protection Agency	D+	DOT Department of Transportation	D-
SBA Small Business Administration	D+	AID Agency for International Development	F
HHS Department of Health and Human Services	D	FEMA Federal Emergency Management Administration	F
HUD	D	Agriculture	F

Department of Housing and Urban Development		Department of Agriculture	
Interior Department of the Interior	D	DOD Department of Defense	F
VA Department of Veterans Affairs	D	NASA National Aeronautics and Space Administration	F
		Governmentwide Grade	D

Prepared for Subcommittee Chairman Stephen Horn, Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations, April 9, 2002.

E. ADDITIONAL FINANCIAL MANAGEMENT OVERSIGHT HEARINGS

In addition to its April 9 hearing on the fiscal year 2001 financial audit results and scorecard, the subcommittee held a number of other hearings on financial management issues.

"The Internal Revenue Service: The Commissioner's Final Report," April 15, 2002. This hearing focused on the progress being made by the Internal Revenue Service [IRS] in addressing its long-standing management and performance problems. This hearing highlighted the need for continued involvement and commitment by IRS senior management to ensure that the IRS successfully addresses its serious financial management problems.

The IRS is responsible for collecting taxes, processing tax returns, pursuing collection of amounts owed, and enforcing tax laws. In fiscal years 2000 and 2001, the IRS collected over $2 trillion in tax payments, processed over 210 million tax returns, and paid about $251 billion and $194 billion, respectively, in refunds to taxpayers.

The IRS prepares financial statements on its custodial operations—revenues collected, refunds paid, and related taxes receivable and payable—and its administrative activities. During the fiscal year 2001 audit, the GAO found that "one of the largest obstacles facing IRS management today is that the agency still does not have a financial management system capable of producing reliable and timely information its managers need to make day-to-day decisions." [12]

The agency continues to experience pervasive internal control weaknesses that have been reported on by the GAO since fiscal year 1992. In fiscal year 2001, for the 2nd consecutive year, the IRS received a clean opinion on its financial statements. However, as in previous years, because of serious systems and control weaknesses, the IRS again relied extensively on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts to derive its financial statements. The GAO noted that the IRS has corrected or mitigated many of the computer security weaknesses cited in previous reports, and is implementing a computer security program that should, when fully implemented, help to manage its risks in this area. However, the GAO noted that security weaknesses continue to exist in the IRS's computing environment.

The Commissioner of the IRS noted that the IRS can be proud of its progress over the past year.

"The Department of Defense: What is Being Done to Resolve Long-standing Financial Management Problems?" March 20, 2002. This hearing focused on the status of financial management at the Department of Defense.

The Department of Defense is the largest of the 14 Cabinet-level departments. As noted previously, it has been cited as the largest impediment to an unqualified opinion on the consolidated financial statements. For the past 4 years, the Inspector General has been unable to render an opinion on the Department of Defense's financial statements. For fiscal year 2001, the Department's Inspector

[12] *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements,* GAO–02–414, Feb. 27, 2002.

General issued another disclaimer on the Department of Defense's financial statements. The Under Secretary of Defense (Comptroller) has acknowledged that the Department's financial management and feeder systems do not provide adequate evidence to support various material amounts on the financial statements.

Section 1008 of the National Defense Authorization Act for fiscal year 2002 directs the Department's Inspector General to perform only the minimum audit procedures required by auditing standards for year-end financial statements that management acknowledges are unreliable. The act also directs the Inspector General to redirect any audit resources freed up by that limitation to be used to improve the Department's financial systems. For fiscal year 2001, the department's Inspector General limited its internal control review to following up on the status of corrective actions relating to material weaknesses that had been reported in prior audits. In addition, auditors performed limited tests of the Department's compliance with laws and regulations. They did not test for compliance with Federal Financial Management Improvement Act, but rather relied on management's acknowledgment that many critical financial management systems do not comply with the act.

The GAO stated that the Department of Defense faces financial management problems that are complex, longstanding, and deeply rooted in virtually all business operations throughout the department. In September 2001, Secretary of Defense Donald Rumsfeld announced a departmentwide initiative intended to transform the full range of the Department's business processes, including decades-old financial systems that are not integrated.

In addition to its longstanding financial management systems problems, the Department of Defense cannot account for the billions of tax dollars expended on its purchase and travel card programs. During the 107th Congress, the subcommittee held six hearings on this subject. The subcommittee learned from these hearings that ineffective controls and lack of oversight have resulted in fraudulent and serious abuse in the travel and purchase credit card programs at the Department.

"The National Aeronautics and Space Administration: What Went Wrong?" March 20, 2002. This hearing focused on the status of financial management for fiscal year 2001 and on actions the National Aeronautics and Space Administration [NASA] is taking to resolve its financial management problems.

Until fiscal year 2001, NASA had received unqualified opinions on its financial statements. For the past 5 years, NASA's Office of the Inspector General contracted with the independent certified public accounting firm of Arthur Andersen to audit its financial statements. During this period, Arthur Andersen auditors consistently reported that NASA's financial statements were fairly stated and they issued unqualified opinions.

However, for fiscal year 2001, the Office of the Inspector General contracted with PricewaterhouseCoopers to audit NASA's financial statements. PricewaterhouseCoopers auditors reported that they were unable to determine whether the financial statements for fiscal year 2001 were reliable. Auditors issued a disclaimer on these statements because of significant internal control weaknesses. In addition, for the past 4 years, NASA's financial management sys-

tems were reported in compliance with the Federal Financial Management Improvement Act. This year, however, PricewaterhouseCoopers concluded that the agency's systems were not in compliance with the act.

The GAO noted that NASA's financial management problems are not new. NASA has been on the GAO high-risk list for contract management since 1990. In addition, the fiscal year 2001 audit report identified a number of significant internal control weaknesses related to accounting for space station material and equipment, and computer security.

"H.R. 4685, the Accountability of Tax Dollars Act of 2002," May 14, 2002. On May 8, 2002, Representative Patrick Toomey (R–PA) introduced H.R. 4685, the "Accountability of Tax Dollars Act of 2002." This bill would expand the number of Federal agencies required to prepare audited financial statements to include all Federal agencies with total annual budget authority of $25 million. The subcommittee's hearing examined the merits of this bill and also heard testimony from Federal agencies on the merits of audited financial statements.

In 2001, the GAO conducted a survey of 26 non-CFO Act agencies. The GAO found that within the past 5 years, 12 of these agencies were preparing annual financial statements and were having them audited. The remaining 14 agencies prepared financial statements but did not have them audited. The survey also found that 21 of the 26 agencies believe that it is beneficial to have audited financial statements.

Witnesses agreed that audited financial statements are beneficial, but some had concerns about the costs associated with these audits. As the CFO Act has shown, requiring Federal departments and agencies to prepare and have audited annual financial statements can contribute significantly to their ability to provide reliable, timely and useful information. Enactment of this legislation would help ensure greater accountability of the billions of tax dollars the Federal Government spends each year.

"The Federal Financial Management Improvement Act of 1996: Are Agencies Meeting the Challenge?" June 6, 2002. Most Federal agencies cannot produce the financial information they need to manage their day-to-day operations efficiently and effectively. In enacting the CFO Act in 1990 and other financial management legislation, Congress sought to improve this longstanding problem. The Federal Financial Management Improvement Act of 1996 [FFMIA] builds on the CFO Act by emphasizing the need for agencies to have systems that can generate reliable, timely, and useful information with which to make informed decisions.

On June 6, 2002, the subcommittee held an oversight hearing on the status of the 24 CFO Act agencies in implementing the FFMIA. The hearing focused on the challenges confronting the 24 major Federal departments and agencies in their efforts to comply with the requirements of the act.

The GAO noted that many agencies continue to struggle with complying with the FFMIA because of the overall longstanding poor condition of many financial management systems throughout the Government. Most systems were originally designed and developed years ago and do not meet current systems requirements. As

a result, these "legacy" systems cannot provide reliable financial information for key governmentwide initiatives, such as integrating budget and performance information. Efforts to implement commercial off-the-shelf software frequently run over budget and require long implementation periods. The weaknesses reported by auditors ranged from serious, pervasive systems problems to less serious problems that may affect one aspect of an agency's operation. The GAO noted six primary reasons why agencies are not complying with FFMIA: (1) nonintegrated financial management systems; (2) inadequate reconciliation procedures; (3) untimely recording of financial information; (4) noncompliance with the Federal Government's Standard General Ledger; (5) failure to adhere to Federal accounting standards, and (6) weak security over information systems.

The GAO also noted one especially significant fact. Even though more agencies received unqualified or clean audit opinions, their ongoing noncompliance with FFMIA's requirements prevent these same agencies from meeting the intent of the financial management reform legislation—to report reliable, useful and timely financial information. Twenty of 24 CFO Act agencies did not have financial management systems that comply with FFMIA, even though 14 of these agencies received clean audit opinions. According to the GAO, these clean audit opinions are attained only by agencies expending significant resources on extensive ad hoc procedures.

Meeting the requirements of FFMIA presents longstanding, significant challenges that will be attained only through time, investment and sustained emphasis. The subcommittee learned at this hearing that to achieve the financial management improvements envisioned by the CFO Act, FFMIA and more recently the President's Management Agenda, agencies need to modernize and integrate their financial systems to generate reliable, useful, and timely financial information throughout the year and at year-end. As noted by the GAO, "a strong commitment from the President, the Joint Financial Management Improvement Program principals, and the Secretaries of major departments and agencies is critical to the success of efforts underway."[13] That type of management commitment must be clearly demonstrated if the goals of FFMIA are to be met.

"Medicaid Claims: Who's Watching the Money?" June 13, 2002. Medicaid is the third largest social program in the Federal budget and one of the largest components of State budgets. The Centers for Medicare and Medicaid Services, a component of the Department of Health and Human Services, administers the Medicaid program. Although it is a Federal program, Medicaid consists of 56 distinct programs—including one for each State, U.S. territory, Puerto Rico, and the District of Columbia. Medicaid provides healthcare for 40 million low-income residents. In fiscal year 2001, the program was projected to cost the Federal Government about $124 billion and State governments about $95 billion in program and administrative expenses.

[13] "Financial Management: Effective Implementation of FFMIA Is Key to Providing Reliable, Useful, and Timely Data," GAO–02–791T, June 6, 2002.

The subcommittee's hearing focused on the oversight of Medicaid expenditures by Federal and State governments and the actions taken to ensure the propriety of the Medicaid claims. The GAO found that the Centers for Medicare and Medicaid has financial oversight weaknesses that leave the Medicaid program vulnerable to improper payments. The OMB reported to Congress that the Government made $12.1 billion in erroneous Medicare payments last year. However, there is no mechanism in place to estimate the amount of erroneous or improper payments that may have been in the Medicaid program. The Principal Deputy Inspector General of the Department of Health and Human Services noted that the Centers for Medicare and Medicaid is in the early stage of putting together a demonstration project in nine States to develop with a methodology to identify Medicaid improper payment rates.

"The Single Audit Act: Is it Working?" June 26, 2002. The Single Audit Act, as amended, requires State and local governments and nonprofit organizations that annually expend $300,000 or more in Federal awards to have audits conducted in accordance with OMB Circular A–133, *Audits of States, Local Governments, and Non-Profit Organizations.* Federal awards include grants, loans, guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations and Federal cost reimbursement contracts. According to the OMB, in fiscal year 2001, the Federal Government awarded about $325 billion to State and local governments, and nonprofit organizations. The Single Audit Act is intended to promote sound financial management, including effective internal controls over Federal awards.

The subcommittee's hearing focused on how Federal agencies are using the results of the single audits and the actions they are taking to ensure that the deficiencies identified in the audits are corrected. The GAO noted three issues that merit additional attention. These issues involve questions about whether (1) all required audits are being performed, (2) recipients are properly monitoring sub-recipients, and (3) the quality of audits being performed. The Controller for OMB also emphasized the need for improved audit quality and noted that the quality of audits is inconsistent.

The subcommittee also learned at this hearing that OMB plans to increase the single audit threshold from $300,000 to $500,000. The OMB noted that this increase reduces the burden on smaller non-Federal entities and concentrates scrutiny where the Federal risk is the greatest. The GAO basically supports OMB's increased audit threshold. However, the GAO emphasized the need for continued monitoring of sub-recipients.

F. THE ADMINISTRATION IS TAKING THE LEAD ON FINANCIAL MANAGEMENT IMPROVEMENT

The "President's Management Agenda," which President Bush issued in August 2001, consists of 14 priority management-improvement initiatives. These initiatives target the core management and capacity problems that face the Federal Government. Congressional committees, the General Accounting Office, and agency Inspectors General have repeatedly documented the seriousness and persistence of these problems.

One of the five governmentwide initiatives is Improved Financial Performance. This initiative seeks to improve the timeliness and usefulness of financial information. It also seeks to reduce erroneous payments made by Federal agencies.

The President's fiscal year 2003 Budget, released on February 4, 2002, includes a "scorecard" that provides a baseline evaluation of where Federal agencies currently stand on each of the five governmentwide initiatives. The scorecard issued by the OMB uses a "traffic light" system: green for success, yellow for mixed results, and red for unsatisfactory. Red is by far the predominant color in the initial scoring. The total 130 scores for 26 agencies include 110 reds, 19 yellows, and only 1 green.

With respect to financial management, 21 of the 26 agencies evaluated received unsatisfactory red scores. Four agencies received yellow scores for mixed results. Only one agency—the National Science Foundation—received a green score for success in financial management.

The budget establishes specific criteria for each of the five initiatives that provide the basis for the scores. The criteria serve as goals for success in each of the five areas, and thereby give agencies a road map on how to get from red to green. Officials in the OMB did the scoring. According to the OMB, the President personally discussed the scores with agency heads during their budget reviews. The OMB will evaluate agencies every 6 months on their progress toward improving. A new round of scores will be included in each future budget.

The President's Management Agenda, the OMB scorecard and the President's fiscal year 2003 budget reflect an unprecedented leadership commitment toward improving the performance of the Federal Government in financial management and other chronic problem areas. The scorecard, with its specific goals for success and systematic evaluations, should serve as a catalyst for resolving core management problems that have plagued the Federal Government for decades.

IV. RECOMMENDATIONS

Although the Federal Government's financial management problems are deep-seated and severe, they are also solvable. Congressional oversight committees, the GAO and agency Inspectors General have proposed hundreds of specific recommendations to resolve these problems. The administration, the OMB and the agencies themselves clearly recognize the root causes of the problems and their solutions.

The subcommittee offers the following recommendations toward achieving the specific solutions that are already well documented.

- Above all else, sustained leadership commitment to fix the problems and persistent follow-up until the job is done is needed. Such leadership must come from both the executive branch and Congress. As discussed previously, the actions needed to resolve the Federal Government's financial management problems are well known. Leaders must now supply the political will and commitment to implement these solutions. The President and the OMB are demonstrating the kind of leadership that is need-

ed. Congress must do its part through the appropriations and oversight processes.

- Strong oversight is one of Congress's most effective tools in the effort to ensure that executive branch departments and agencies implement necessary legislative reforms. To build upon this, Congress needs to conduct regular oversight hearings to review the status of agencies' progress toward improving financial management, including planned actions to resolve related problems. When appropriate, each department or agency should be regularly reviewed by its oversight, authorization and appropriations subcommittees regarding its progress in reforming its financial management systems and processes. These hearings should be held annually, semiannually or quarterly, depending on the severity of the financial problems within the department or agency. This would assist Congress in effectively monitoring agency progress and taking corrective actions as necessary.
- The administration and Congress must provide the necessary resources to replace or re-engineer dysfunctional financial systems. In most cases, the resource investments needed to improve financial management systems are quite modest in relation to the benefits to be achieved. However, funding financial management improvements tends to be a low priority in this era of tight budgets and competing needs. Nevertheless, such investments will repay themselves many times over in reduced fraud, waste and abuse and increased efficiency.
- Accountability and incentives to produce results must accompany resources. Agencies should establish results-oriented and measurable performance goals for financial management improvements. For example, agencies need to establish specific performance goals to reduce improper payments. Agencies also should establish measurable goals for improvements to their underlying financial management systems. Such goals need to be more sophisticated than simply getting clean audit opinions and complying with applicable legal requirements.
- The administration and Congress must provide appropriate oversight to ensure that financial management improvement resources are applied wisely and that performance goals are met. It is clear that congressional oversight alone cannot effect the necessary change in financial management practices at all departments and agencies. The subcommittee again notes that incentives are needed to prompt agencies to resolve their outstanding financial management problems. If an agency is unable or unwilling to effect these crucial changes, Congress has the authority to provide incentives for change. These incentives include: (1) redirecting a percentage of the agency's appropriated program or administrative funding toward correcting financial management problems; (2) restricting a percentage of the agency's appropriated funds until the problems are corrected; or (3) reducing various amounts of appropriated funds until the agency has completed its correction efforts. Furthermore, reducing appropriated funds should be considered for all agencies failing to comply with the OMB's accelerated reporting deadlines.
- Although the basic statutory framework for achieving financial management success is already in place, the enactment of two

additional measures would complement the existing framework. H.R. 4878, the "Improper Payments Information Act of 2002," would require agencies to identify systematically areas in which they are vulnerable to making erroneous payments and to report on steps they are taking to reduce these vulnerabilities. H.R. 4685, the "Accountability of Tax Dollars Act of 2002," extends to most executive branch agencies the requirement for audited annual financial statements that now applies only to the largest agencies. Both of these bills should be enacted into law.

- The administration, the OMB and the individual agencies need to follow through in implementing the financial management improvement initiatives in the President's Management Agenda. In particular, the OMB needs to follow through on its financial management scorecard by periodically updating its evaluations in an objective and transparent way. To achieve success in financial management, agencies must comply with the Federal Financial Management Improvement Act. To determine compliance with this act, it is imperative that auditors perform sufficient testing of agencies' systems and provide positive assurance or issue an opinion. Currently, OMB Bulletin 01–02, *Audit Requirements for Federal Financial Statements,* does not require auditors to make an affirmative statement regarding an agency's compliance with the act. Rather, it permits auditors to report negative assurance, meaning that their report can be based on limited audit testing that disclosed no substantial instances of noncompliance. In recent correspondence to the OMB, this subcommittee expressed concern with the language in the OMB's guidance and requested that it be changed. The OMB should change its guidance to require an affirmative opinion on compliance with the act.
- Finally, the GAO, Inspectors General and congressional committees should vigorously pursue their independent auditing and oversight of agencies' efforts to improve their financial management systems and practices. This oversight should include, but not be limited to, an examination of agencies' success in meeting the criteria contained in the President's Management Agenda and the OMB scorecard.

APPENDIX A—MAJOR FEDERAL FINANCIAL MANAGEMENT LEGISLATION

Public Law	Key Financial Management Provisions
Budget and Accounting Procedures Act of 1950 (Chapter 946, 64 Stat. 832)	• The Budget and Accounting Procedures Act of 1950 (BAPA) provided that the maintenance of accounting systems and production of financial reports with respect to the operations of Executive agencies be the responsibility of the Executive branch, and that the auditing for the Government be conducted by the Comptroller General to determine the extent to which accounting and related financial reporting fulfill the purposes specified, financial transactions have been consummated in accordance with laws, regulations, or other requirements, and adequate internal financial control over operations is exercised. • The Comptroller General was given the responsibility of prescribing accounting and auditing principles and standards to be followed in the preparation of financial reports by Executive agencies and by the GAO in the audit of the financial transactions of each Executive, Legislative, and Judicial agency.
Inspector General Act of 1978, as amended by the Inspector General Act Amendments of 1988 (P.L. 95-452 and 100-504)	• The Inspector General Act (IG Act) requires that Inspectors General perform audits in accordance with generally accepted Government auditing standards. • The Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act and amended by the Federal Financial Management Improvement Act, has demanded shifts in focus by the Inspectors General.
Federal Managers' Financial Integrity Act of 1982 (P.L. 97-255)	• The Federal Managers' Financial Integrity Act of 1982 (FMFIA) required that internal accounting and administrative controls of each Executive agency be established in accordance with standards prescribed by the Comptroller General, and shall provide reasonable assurance that: obligations and costs are in compliance with applicable law; assets are safeguarded from waste, loss, unauthorized use, or misappropriation; and revenues and expenditures applicable to agency operations are properly recorded and accounted for. • The head of each agency is required to report to the President and

	Congress whether the agency's systems of internal accounting and administrative control fully comply with the Comptroller General's requirements. For all material weaknesses, the agency head must describe in the report the plan and schedule for correcting any such weaknesses.
Debt Collection Act of 1982, as amended, and Debt Collection Improvement Act of 1996 (P.L. 97-365 and 104-134, sec. 31001)	• The Debt Collection Act, as amended, provides greater powers to Federal agencies in collecting debts owed to the Federal Government including: reporting a delinquent debtor to a consumer reporting agency; offsetting the salary of Federal employees who are delinquent in the payment of debts; disclosing to a Federal lending agency that an applicant has a tax delinquency and denying such individual credit; disclosing a taxpayer's address to an agency for purposes of collecting delinquent debt; administratively offsetting all Federal payments, including tax refunds; garnishing wages; and charging interest and penalties on any debt. • Agencies are required to report to the Director of the Office of Management and Budget and the Secretary of the Treasury at least once a year information regarding its debt-collection activities. Further, the Secretary of the Treasury must report that information to Congress annually and provide a one-time report, no later than April 1999, to Congress on the collection services provided by it and other entities collecting debts on behalf of Federal agencies. • Agencies are required to make Federal payments to individuals by electronic fund transfer, except for tax refunds. • Agencies, except for the IRS, can contract with a collection service to pursue outstanding debts to the agency or to sell debts over 90-days delinquent. • Agencies are required to collect the taxpayer identification number of any individual or entity doing business with the Government.

Chief Financial Officers Act of 1990 (P.L. 101-576)	• The Chief Financial Officers Act of 1990 (CFO Act) creates a new leadership structure for Federal financial management, including the creation of a Deputy Director of Management, a Controller who advises the Deputy Director, and an Office of Federal Financial Management within the Office of Management and Budget. The Deputy Director is responsible for providing financial management leadership including the establishment and oversight of Federal financial policies and practices. • The Office of Management and Budget is required by the CFO Act to prepare and submit to Congress a Governmentwide five-year financial management plan. The plan must describe the planned activities of the OMB and the agency CFOs during the next five years to improve financial management • The CFO Act also requires that 24 agencies have Chief Financial Officers and Deputy Chief Financial Officers, and lays out their authorities and functions. It also stipulates the qualifications and responsibilities for each of the positions.

Government Management Reform Act of 1994 (P.L. 103-356)[14]	• Government Management Reform Act of 1994 (GMRA) expands requirements for Executive Branch agencies contained in section 303(a) of the CFO Act. • GMRA requires all 24 agencies covered under the CFO Act to have agencywide audited financial statements, beginning with fiscal year 1996. Those statements are due on March 1, 1997 and each year thereafter, and must cover all accounts and associated activities. • GMRA provides that for each audited financial statement required from the agency, the auditor (the Inspector General, independent public accountant, or GAO) must submit a report on the audit to the head of the agency. This report is to be prepared in accordance with generally accepted Government auditing standards. • GMRA requires that a consolidated financial statement for all accounts and associated activities of the Executive branch be prepared by the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, for fiscal year 1997 and each year thereafter. Such statements are to be audited by the Comptroller General. The audited financial statements must be submitted to the President and Congress by March 31 of each year.
Federal Financial Management Improvement Act of 1996 (Title VIII of P.L. 104-208)	• The Federal Financial Management Improvement Act of 1996 (FFMIA) requires that agencies conform to promulgated Federal Government accounting and systems standards, and use the U.S. Government standard general ledger. • FFMIA requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with Federal accounting standards, financial systems requirements, and the Government's standard general ledger at the transaction level. • For agencies that are not in material compliance with the standards described above, the head of the agency, in consultation with the Director of the Office of Management and Budget, must

[14] The section of GMRA that deals with financial management is also referred to as the "Federal Financial Management Act of 1994."

	prepare a remediation plan that addresses the problems. This plan shall include resources, remedies, and intermediate target dates necessary to bring the agencies' financial management systems into substantial compliance. The remediation plan shall bring the agency's financial management systems into substantial compliance within 3 years from the date auditors determine the agency is not in compliance. • The Director of the Office of Management and Budget is required to report to Congress, no later than March 31 of each year, regarding implementation of FFMIA. • The Comptroller General is required to report to Congress, no later than October 1 of each year, concerning compliance with the requirements of FFMIA and the adequacy of applicable accounting standards of the Federal Government.

APPENDIX B.—BASIS FOR AGENCY FINANCIAL MANAGEMENT GRADES

This is the 5th year that the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations (and its predecessor subcommittee) has issued a report card on the status of financial management at the 24 Federal agencies that are subject to the Chief Financial Officers Act. The report card grades each agency's progress in achieving good financial management.

In previous years, the subcommittee based its grades on the agencies' annual audited financial statements, required under the Government Management Reform Act of 1994. The grades for each of the 24 departments and agencies are based on the results of the financial statement audits. These audits were performed by the agency's Inspector General, independent public accounting firms, and the General Accounting Office. All auditors were required to follow generally accepted Government auditing standards. These standards incorporate the American Institute of Certified Public Accountant's *Statements on Auditing Standards,* the same standards required for audits of private sector entities. However, Generally Accepted Government Auditing Standards [GAGAS] adds certain requirements beyond the *Statements on Auditing Standards.* Most notably, GAGAS has additional reporting requirements beyond an opinion on the financial statements.

Three reports are required at the completion of each audit of Government entities under GAGAS and as incorporated in OMB Bulletin 98–08, *Audit Requirements for Federal Financial Statements.* These reports are an opinion of the financial statements, a report on internal controls, and a report on compliance with laws and regulations.

The opinion provides the auditor's assessment of the reliability of the information contained in the financial statements. There are four types of opinions that the auditor can render—Unqualified, Qualified, Adverse, or Disclaimer. An *unqualified* opinion signifies that the information in the financial statements was reliable in all material respects.

A *qualified* opinion signifies that, except for specified information in the financial statements, the information is reliable. An *adverse* opinion means the statements are not reliable. Last, a *disclaimer* of opinion signifies that the auditor was unable to determine if material information in the statements was reliable.

The report on internal control provides an assessment by the auditors of the effectiveness of internal controls. The report is required to identify any instances of material weaknesses or reportable conditions in internal controls that surfaced during the course of the audit. The American Institute of Certified Public Accountants defines a material weakness in internal controls as ". . . a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may

occur and not be detected within a timely period by employees in the normal course of performing assigned functions."[15]

The report on compliance with the laws and regulations provides the auditor's assessment of instances in which the agency did not follow or conform materially to requirements of the laws and regulations deemed material to the financial operations of that agency. The Office of Management and Budget also provides guidance to the auditors in OMB Bulletin 98–08 regarding which general laws and regulations need to be considered during the audit.

Starting with fiscal year 1997, an agency's adherence to FFMIA must be assessed in the report on compliance with laws and regulations, in accordance with OMB guidance. FFMIA specifically requires that agencies conform to promulgated Federal Government accounting and systems standards, and use the Government standard general ledger. Many agencies did not materially conform to the requirements of FFMIA.

The subcommittee reviewed each financial report on an absolute scale and assessed grades on a 4 point scale with "A" = 4, "B" = 3, "C" = 2, "D" = 1, "F" = 0. In the audit opinion category, an unqualified, or "clean," opinion earned 4 points. A qualified opinion received 2 points; and a disclaimer received 0 points.[16] If auditors reported no material weaknesses in internal controls, the agency received 4 points. Conversely, if material weaknesses were reported, the agency received 0 points in that category. If auditors reported that the agency appeared to be in compliance with Federal financial management laws and regulations, the agency received 4 points. Any reports of material noncompliance resulted in 0 points.

The points in the three categories were then averaged (with equal weight) to determine the overall grade for the agency. Thus, if an agency received an unqualified audit opinion and the auditors reported no material internal control weaknesses or instances of non-compliance, the agency received a grade of A (4+4+4=12÷3=4).

This year, the subcommittee has added four new categories to its grading criteria. These additional categories place greater emphasis on whether agency financial systems can produce reliable and useful data on a real-time basis to support day-to-day management and policymaking. This is consistent with the view espoused by the General Accounting Office, the Office of Management and Budget and other experts that a successful financial management program requires much more than simply getting an unqualified audit opinion and complying with legal and accounting requirements.[17] The subcommittee's new grading criteria also come closer to the executive branch Management Scorecard, which sets more demanding standards for financial management success.

The four new grading categories are based on the results of a survey that the subcommittee sent to the Inspectors General of the 24 agencies. The categories are as follows:

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[15] *Codification of Statements on Auditing Standards (Including Statements on Standards for Attestation Engagements), Numbers 1 to 82,* American Institute of Certified Public Accountants, as of Jan. 1, 1997; AU Section 325.15.

[16] There were no adverse opinions rendered in fiscal years 1996 through 2001; however, an adverse opinion would have also received 0 points.

[17] Indeed, an unqualified audit opinion may actually be a misleading indicator that masks weaknesses in an agency's financial management systems. Many Federal agencies achieve "unqualified" opinions only through time-consuming and costly manual efforts that work around, rather than rely upon, the agency's systems.

- Whether this year's financial statements were prepared from data produced routinely by the agency's financial management systems;
- Whether the agency's financial and performance management systems were integrated;
- Whether the agency's financial systems contained complete and reliable data on the costs of its programs and activities;
- Whether the agency's financial systems provided timely, accurate and useful data to support day-to-day management and policymaking.

The possible responses to each of the four categories were "entirely," "for the most part," and "to a limited extent or not at all." Agencies received 4 points for a response of "entirely;" 2 points for the response of "for the most part;" and 0 points for "to a limited extent or not all."

This year, the subcommittee gave equal weight to the three categories used in prior years and the four new categories. Thus, agency grades are based on the total points assigned for each category divided by seven.[18]

The subcommittee believes that the revised grading criteria provide a more accurate measure of financial management successes than the former criteria. At the same time, the subcommittee regards the new criteria only as a starting point toward defining a truly successful financial management program.

[18] In addition to the four questions described above, the subcommittee also asked the Inspectors General whether their agencies had violated the Anti-deficiency Act (i.e., overspent their appropriation accounts) for fiscal year 2001. The responses to this question were not factored into the grades since only two agencies—the Departments of Defense and Agriculture—had actual or potential violations, and they both received failing grades irrespective of these violations.

APPENDIX C.—INDEX OF WITNESSES

ALDERMAN, Karen C., executive director, Joint Financial Management Improvement Program, June 6, 2002.

BLANCHARD, Lloyd A., Ph.D., Chief Operating Officer, Small Business Administration, June 6, 2002.

BRACHFIELD, Paul, Inspector General, National Archives and Records Administration, May 14, 2002.

BLOOM, Thomas R., Director, Defense Finance and Accounting Service, Department of Defense, March 20, 2002.

CALBOM, Linda M., Director, Financial Management and Assurance, U.S. General Accounting Office, June 13, 2002.

CARTER, Thomas A., Assistant Inspector General for Audit Services, Department of Education, June 26, 2002.

DOONE, Alison L., deputy staff director for management, Federal Election Commission, May 14, 2002.

ENGEL, Gary T., Director, Financial Management and Assurance, U.S. General Accounting Office, May 14, 2002.

EVERSON, Mark W., Controller, Office of Federal Financial Management, Office of Management and Budget, April 9, 2002, and June 26, 2002.

JONAS, Tina W., Deputy Under Secretary for Defense, Financial Management, Department of Defense, March 20, 2002.

HAMMOND, Donald V., Fiscal Assistant Secretary, Department of the Treasury, April 9, 2002.

HANSON, Elizabeth A., Director, Departmental Real Estate Assessment Center, Dept. of Housing and Urban Development, June 26, 2002.

HINTON, Russell W., chair, Single Audit Committee, National Association of State Auditors, Controllers and Treasurers, June 26, 2002.

HITE, Randolph C., Director, Information Technology Systems, U.S. General Accounting Office, March 20, 2002.

KNICKERBOCKER, Frederick T., Associate Director for Economic Programs, U.S. Census Bureau, June 26, 2002.

KUTZ, Gregory D., Director, Financial Management and Assurance, U.S. General Accounting Office, March 20, 2002.

LAMOREAUX, Alan J., Assistant Inspector General for Audits, National Aeronautics and Space Administration, March 20, 2002.

LI, Allen, Director, Acquisition and Sourcing Management, U.S. General Accounting Office, March 20, 2002.

LIEBERMAN, Robert J., Deputy Inspector General, Department of Defense, March 20, 2002.

MADDOX, Charles C., IG, District of Columbia, District of Columbia Medicaid Fraud Control Unit, June 13, 2002.

MANGANO, Michael F., Principal Deputy Inspector General, OIG, Department of Health and Human Services, June 13, 2002.

MARTIN, Jack, Chief Financial Officer, Department of Education, June 26, 2002.

MCLEAN, Donna R., Assistant Secretary for Budget and Programs and Chief Financial Officer, DOT, June 6, 2002.

MCNAMEE, Patrick L., partner, PricewaterhouseCoopers LLP, March 20, 2002.

PASTOREK, Paul G., General Counsel, National Aeronautics and Space Administration, March 20, 2002.

RITCHIE, De W., Jr. Acting Deputy Chief Financial Officer Department of Defense, March 20, 2002.

REGER, Mark A., Chief Financial Officer, Federal Communications Commission, May 14, 2002.

ROCKE, Sidney, director, District of Columbia Medicaid Fraud Control Unit, June 13, 2002.

THOMPSON, Sally E., Director, Financial Management and Assurance, U.S. General Accounting Office, June 6, 2002, and June 26, 2002.

TOOMEY, Hon. Patrick J. (R–PA), U.S. House of Representatives, May 14, 2002.

SMITH, Dennis, director, Centers for Medicaid and State Operations, June 13, 2002.

VARHOLY, Stephen J., Deputy Chief Financial Officer, National Aeronautics and Space Administration, March 20, 2002.

WALKER, David M., Comptroller General of the United States, U.S. General Accounting Office, April 9, 2002.

WARREN, David R., Director, Defense Capabilities and Management, U.S. General Accounting Office, March 20, 2002.

ZIRKEL, Frederick J., Inspector General, Federal Trade Commission, May 14, 2002.

