FEDERAL CONSOLIDATED FINANCIAL STATEMENTS: CAN THE FEDERAL GOVERNMENT BALANCE ITS BOOKS?

HEARINGS

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

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FEDERAL CONSOLIDATED FINANCIAL STATEMENTS: CAN THE FEDERAL GOVERNMENT BALANCE ITS BOOKS?

WEDNESDAY, APRIL 1, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT, MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:36 a.m., in room 2141, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Davis, Sanford, Sessions, Kucinich, and Turner.

Staff present: J. Russell George, staff director and chief counsel; John Hynes, professional staff member; Matthew Ebert, clerk; and Mark Stephenson, minority professional staff member; and Faith Weiss, minority counsel.

Mr. HORN. The Committee on Government Management, Information, and Technology will come to order.

We're here today to review the first ever audit of the Federal Government's consolidated financial statements. This audit is required by law, a law passed in 1994. Roughly 4 to 5 years were given to the executive branch to implement the law. And to clarify what we're about, it's worth quoting the specific requirement. The Government Management Reform Act of 1994 reads: "Not later than March 31 of 1998, and each year thereafter, the Secretary of the Treasury in coordination with the Office of Management and Budget, shall annually prepare and submit to the president and Congress an audited financial statement for the preceding fiscal year covering all accounts and associated activities of the executive branch of the U.S. Government. The financial statement shall reflect the overall financial position, including assets and liabilities, and the results of operations of the executive branch of the Government of the United States."

The required audit, conducted by the General Accounting Office, an office of very valuable service within the legislative branch, was released yesterday.

When we scheduled the hearing for today, we thought of a few April Fools' jokes about how the Government does a great job of keeping track of the taxpayers' money, but then a good April Fool's joke has to be at least a little bit believable. Unfortunately, it is far too easy to believe that billions of taxpayer dollars are being lost each year to fraud, waste, abuse, and mismanagement throughout the Federal Government.

We've heard it all before, but today, with the Governmentwide audit, we know more about how much money is being wasted, where it is being wasted, and what can be done about it.

We've identified the Government programs especially at risk. For the first time, a concise accounting for the myriad problems faced by the Federal Government is available. It is common to compare the Government with a business. Clearly, the comparison is inexact. Government reflects the needs and the priorities of an entire Nation. However, there are also similarities. Government should be able to account for how much money it does take in. It should be able to determine what it has in inventory, and what it has in liabilities. In short, Government requires effective and responsible management. It requires active and vigorous leadership. And it absolutely must have accurate, timely information on its financial condition.

The first-ever Governmentwide audit demonstrates that we remain far short of these common-sense goals. This is not an exercise in bean counting. Financial statements are the keystones to effective financial management in the Federal Government. If the U.S. Government had to compete as private sector businesses do, we would be out of business very quickly in most operations. The amounts reported in the consolidated financial statements simply do not provide a reliable source of information for decisionmaking by the Government or the public, but we're slowly getting there.

The consequences of poor management are appalling. Consider just a few examples of the waste uncovered by the audit: $23 billion each year in overpayments by the Health Care Financing Administration for Medicare—that is money that could be used to continue current benefits or even to improve the benefits; $1 billion each year in overpayment by the Social Security Administration for the Supplemental Social Insurance program; and $900 million each year in overpayments by the Department of Housing and Urban Development in excess rent subsidies.

The subcommittee's own review of the reports, available for the 24 individual agencies required to report under the Chief Financial Officers Act of 1990, as amended by the Government Management and Reform Act of 1994, found results overall were dismal, with the exception of two agencies, the National Aeronautics and Space Administration and the Department of Energy. All the other agencies had reported deficiencies in at least one of the key areas reviewed by their auditors.

The grades are based on the audited financial statements prepared under the Government Management and Reform Act of 1994 for the 24 cabinet departments and independent agencies covered by that act. These 24 agencies make up 98 percent of the total reported Federal budgetary expenditures for fiscal year 1997.

Almost half of the agencies did not even submit reports by the deadline specified by law years in advance, and that deadline was essentially March 1, 1998. That is months after the end of the Federal Government's fiscal year which ended September 30, 1997, and 5 years after the law requiring the reports was enacted.

Two of the agencies, Housing and Urban Development and the Treasury Department, submitted reports to us late but before the consolidated statements were issued yesterday. The Administration seems to think that getting its statements in late is OK. We don't agree with that. To be credible and useful, the information not only needs to be materially correct, but also timely. Timely means the decisionmakers receive information before the decisions are made, not after.

It's like the old joke in the academic world: the only difference between the "A" student and the "F" student is the "F" student forgot it before the exam. So we hope to improve on that.

As you can see from the grades on that chart over there, which were done by the specialists and accountants on the subcommittee staff, the Federal Government has a long way to go in fixing its financial management problems. Only 2 of the 24 agencies earned a clean bill of financial health across the board. This report includes not only a clean opinion, but also no material internal control weaknesses, and no areas of noncompliance with laws and regulations material to the financial information presented.

Many of the agencies are hindered by poor financial systems. Poor systems prevent them from having good financial data on a regular basis. Those agencies with poor systems but reliable data required significant adjustments, often based on its auditor's recommendations to its statements to make them reliable. Both the General Accounting Office audit report and the individual agency audit reports tell the sorry story of deficient financial statements, systems rife with problems, and a general failure to comply with laws and regulations. The unaudited statements are riddled with gaps, filled with unreliable numbers.

This report should be a call to action by the administration to fix longstanding problems and become accountable to the American people. We have been warned: our ship of State is perceived as unsinkable, but this audit has alerted us to the serious dangers. It is hubris to think we can avoid these dangers without reliable financial information. But we've got to look at it this way, since 1789, there has never been a consolidated financial statement by any part of the Federal Government and certainly not on this scale.

So despite the errors that are still around in some of the data and the failure of many to report—the groups that are noted as incomplete up there—the fact is it does provide a base—inaccurate though some things might be—from which the annual consolidated financial report will be developed. I'm sure it'll improve over time.

We have with us a list of witnesses this morning that will tell us how that will be done and what they encountered in terms of the various departments that were reviewed. The audits were generally held or reviewed by the General Accounting Office. I want to thank them and the Inspector Generals of the various independent agencies and cabinet departments because they, in large part, were the ones that verified the data to make sure that we have a reliable consolidated balance statement, as far as we can go within those departments. So we appreciate all of that hard work, as well as the hard work by the many people in the administration, especially the chief financial officers which didn't exist until Congress created them a few years ago. Just as we've created chief information officers, and we will get to creating chief acquisition officers.

So I'm now prepared to call the first panel, and the first panel will be from the General Accounting Office, Gene Dodaro.

[The prepared statement of Hon. Stephen Horn follows:]

ONE HUNDRED FIFTH CONGRESS

Congress of the United States

House of Representatives

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"Federal Consolidated Financial Statements: Can the Federal Government Balance Its Books?"

April 1, 1998

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management, Information, and Technology

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The required audit, conducted by the General Accounting Office, was released yesterday. When we scheduled the hearing for today, we thought of a few April Fools jokes about how the Government does a great job of keeping track of the taxpayers' money. But then, a good April's Fool joke has to be at least a little bit believable.

Unfortunately, it is far too easy to believe that billions of taxpayer dollars are being lost *each year* to fraud, waste, abuse, and mismanagement throughout the Federal Government. We have heard it all before. But today, with this governmentwide audit, we know more about how much money is being wasted, where it is being wasted, and what can be done about it. We have identified the government programs especially at risk. For the first time, a concise accounting for the myriad problems faced by the Federal Government is available.

It is common to compare the Government with a business. Clearly, the comparison is inexact. Government reflects the needs and priorities of an entire nation. However, there are also similarities. Government should be able to account for how much money it takes in. It should be able to determine what it has in inventory and what it has in liabilities. In short, government requires effective and responsible management. It requires active and vigorous leadership. And, it absolutely must have accurate, timely information on its financial condition.

The first-ever governmentwide audit demonstrates that we remain far short of these common-sense goals.

This is not just an exercise in bean counting. Financial statements are the keystone to effective financial management in the Federal Government. If the U.S. Government had to compete as private sector businesses do, we would be out of business very quickly. The amounts reported in the consolidated financial statements simply do not provide a reliable source of information for decision-making by the Government or the public.

The consequences of poor financial management are appalling. Consider just a few examples of the waste uncovered by the audit:

- $23 Billion EACH YEAR in overpayments by the Health Care Financing Administration for Medicare—that is money that could be used to continue current benefits or even to improve the benefits.
- $1 Billion EACH YEAR in overpayments by the Social Security Administration for the Supplemental Social Insurance program.
- $900 Million EACH YEAR in overpayments by the Department of Housing and Urban Development in excess rent subsidies

The Subcommittee's own review of the reports available for the 24 individual agencies required to report under the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, found results overall were dismal. With the exception of two agencies—NASA and the Department of Energy—all the Agencies had reported deficiencies in at least one of the key areas reviewed by their auditors.

The grades are based on the audited financial statements prepared under the Government Management Reform Act of 1994 for the 24 Federal agencies covered by the Act. These 24 agencies made 98 percent of total reported Federal budgetary expenditures for fiscal year 1997.

Almost half of the agencies did not even submit reports—as required by law—by March 1, 1998. That is months after the end of the Federal Government's fiscal year, and five years after the law requiring these reports was enacted. Two of the agencies, Housing and Urban Development and the Treasury Department, submitted reports to us late but before the consolidated statements were issued yesterday. The Administration seems to think that getting its statements in late is O.K. We do not agree. To be credible and useful the information not only needs to be materially correct but also timely. Timely means that decision-makers receive the information before decisions are made—not after.

As you can see from the grades, the Federal Government has a long way to go in fixing its financial management problems. Only 2 of the 24 agencies earned a clean bill of financial health. This report includes not only a clean opinion but also no material internal control weaknesses and no areas of non-compliance with laws and regulations material to the financial information presented. Many of the agencies are hindered by poor financial systems. Poor systems prevent them from having good financial data on a regular basis. Those agencies with reliable data but ineffective controls had to make significant adjustments, often based on its auditor's recommendations, to its statements to make them reliable.

Both the GAO audit report and the individual agency audit reports tell the sorry story of deficient financial statements, systems rife with problems, and a general failure to comply with laws and regulations. The unaudited statements are riddled with gaps and filled with unreliable numbers. This report should be a call to action by the Administration to fix long-standing problems and become accountable to the American people.

We have been warned. Our ship of State is perceived as unsinkable. But this audit has alerted us to serious dangers. It is hubris to think that we can avoid these dangers without reliable financial information.

Mr. HORN. Mr. Sessions, OK. Yes? No, go right ahead.

The gentleman from Texas is the vice chairman of the subcommittee and I'm delighted to have Mr. Sessions here because he is also chairman of the results caucus of the House of Representatives, and has spent a lot of time on these matters.

Mr. SESSIONS. Mr. Chairman, thank you. As always, Mr. Chairman, I applaud you for conducting this type of valuable oversight, but I must tell you that your hearings are also some of the most depressing and disappointing hearings that we have here in Congress.

Since coming to Washington, I've sat with you as we've learned about major mismanagement of the executive branch of the Federal Government. We've learned that the executive branch is at risk of loss from waste, fraud, and error in many areas above those listed in the GAO high-risk series areas.

The executive branch is poorly managing the year 2000 problem and it looks as though most agencies will be grossly unprepared to meet the coming crisis which is just seven quarters away. The executive branch manages to squander tens and hundreds of billions of dollars as a result of thoughtless planning and information technology modernization and other areas that they are expected to perform related to computer management.

The executive branch, after many years of practice, still fails to produce adequate reports as required under the results act. And as I reviewed the performance plans of Federal agencies, what I wonder is if we're going to go throughout the same exercise again.

But, Mr. Chairman, I have not yet seen a document as damaging as the General Accounting Office's audit of the consolidated financial statements of the U.S. Government. According to GAO, significant financial systems weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, prevent the Government from accurately reporting a large portion of its assets, liabilities, and costs. The executive branch cannot tell how much money it receives, how much money it spends, what it spends money on, what property it has, where the property goes, or how much that property is worth.

As I've said many times before the panel, I spent 16 years in the private sector and I had to account for all the dollars that were spent, not just a part of that which I was given responsibility over. I had to do this because I had a constant battle with the bottom line. That's reality in the private sector, but it's a concept which this executive branch evidently has no experience or desire to improve upon.

Let me quote further from the GAO report, "The systems and data were not available to accurately estimate significant portions of the more than $2.2 trillion reported as Federal employee and Veteran benefits liabilities." That doesn't include the liabilities related to every American under Social Security.

I quote further,

> The Government was unable to support significant portions of more than $1.6 trillion reported as the total net costs of Government operations and much of this is because it was without accurate cost information. The Federal Government is limited in its ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover cost that were required by law. The Government is unable to determine the full extent of improper payments, that is, payments made

for other than valid, authorized purposes. In this regard, estimates of improper payments in major Federal programs, such as Medicaid, Medicare, which totaled billions of dollars annually. Further, the Government currently does not obtain information necessary to identify tax collections by every type of tax at the time it collects that tax. As a result, the Government cannot separately report revenue for three of the four largest revenue sources, Social Security, hospital insurance, and individual income taxes.

Mr. Chairman, these are just a few of the damaging statements made by an objective, professional auditing body, and with which the administration, evidently, completely agrees. I understand that everyone does understand the problem, but the American people need to know that they, or any other corporation that conducted its affairs in this manner, would be subject to a nasty audit by the IRS or SEC. Most likely, they would find themselves heavily fined or prosecuted for criminal misbehavior.

All too often, this is the case. We hold the America people up to a standard which we are unwilling to apply to ourself. I join with you, Mr. Chairman, in decrying the pathetic state of our Government books. I also join with you and many other of our colleagues in pushing for management reforms, but that is where the GAO study is most frustrating. In its disclaimer of opinion, the GAO writes, “Because the Government serious systems, record keeping, documentation, and control deficiency, amounts reported in the consolidated financial statements and related notes do not provide a reliable source of information for decisionmaking by the Government or the public.”

Simply put, Mr. Chairman, this means really that I cannot do my job because, according to the report, we are passing legislation and conducting oversights just like we had blindfolds on because we aren’t sure who is accountable ultimately for this. We cannot do our jobs if the executive branch cannot give us the information that we need. This year’s consolidated financial statements are an important step, not just because we know things are going bad, but because we recognize now more than ever the hard work that is ahead for us.

I think, like you, Mr. Chairman, I want to work carefully with those representatives from the Government to make sure that we avoid these problems in the future. But I want you to know, Mr. Chairman, that I believe that because of our serious endeavor, and only because of our serious endeavor, and the backing of the American public, will we make any headway.

Thank you for the time.

[The prepared statement of Hon. Pete Sessions follows:]

CONGRESSMAN

PETE SESSIONS News

TEXAS, FIFTH DISTRICT

1318 Longworth House Office Building • 202-225-2231 • Contact: Pam Arruda

Statement of the Honorable Pete Sessions (TX)
Vice Chairman
House Subcommittee on Government Management, Information, and Technology
April 1, 1998

As always, Mr. Chairman, I applaud you for conducting this type of valuable oversight. But, I must tell you, your hearings are some of the most depressing, disappointing hearings held in Congress. Since coming to Washington, I've sat with you as we've learned about major mismanagement in the Executive Branch of the federal government. We've learned that:

- the Executive Branch is at risk to loss from waste, fraud, and error in many areas, even above those listed in GAO's High Risk areas;
- the Executive Branch is poorly managing the Year 2000 problem, and it looks as though most agencies will be grossly unprepared for the coming crisis;
- the Executive Branch manages to squander tens and hundreds of billions of dollars as a result of the thoughtless planning in information technology modernization; and
- the Executive Branch, after many years of practice, still failed to produce adequate reports as required under the Results Act, and as I review the performance plans of federal agencies, I wonder if we are going to go through the same exercise.

But, Mr. Chairman, I have not yet seen a document so damning as the General Accounting Office's audit of the Consolidated Financial Statements of the United States Government. According to GAO, "significant financial systems weaknesses, problems with fundamental record keeping, incomplete documentation, and weak internal controls, including computer controls, prevent the government from accurately reporting a large portion of its assets, liabilities, and costs."[1] The Executive Branch can't tell you how much money it receives, how much money it spends, what it spends money on, what property it has, where that property goes, or how much that property is worth.

As I've said many times before this panel, I spent sixteen years in the private sector, and I had to account for everything I had and did to the penny. I had to do this because I was constantly in battle with the bottom line. That's reality in the private sector, but it's a concept with which the Executive Branch has no experience.

Let me quote further from GAO's report:

- "The systems and data were not available to accurately estimate significant portions of the

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[1] Consolidated Financial Statements of the United States Government, Fiscal 1997, at 14.

more than $2.2 trillion reported as federal employee and veterans benefits liabilities."[2] And that doesn't include the liabilities related to every American under Social Security.

- "The government was unable to support significant portions of the more than $1.6 trillion reported as the total net **costs** of government operations. [And] without accurate cost information, the federal government is limited in its ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required."[3]

- "The government is also unable to determine the full extent of improper payments -- that is, payments made for other than valid, authorized purposes. In this regard, estimates of improper payments in major federal programs, such as Medicare, total in the billions of dollars annually."[4]

- "The government currently does not obtain information necessary to identify tax collections by every type of tax at the time of collection. As a result, the government cannot separately report revenue for three of the four largest revenue sources - Social Security, Hospital Insurance, and individual income taxes."[5]

Mr. Chairman, these are just a few of the damning statements by an objective, professional auditing body, and with which the Administration completely agrees. I understand that everyone understands the problem. But, the American people need to know that if they or if any corporation conducted its affairs in this manner, they would be the subject of a nasty audit by the IRS or SEC, and would likely end up in jail. As is too often the case, we hold the American people to a standard we are unwilling to apply to ourselves.

I join you, Mr. Chairman, in decrying the pathetic state of our government's books. I also join you and many of our colleagues in pushing for management reform. But, that's where the GAO audit is most frustrating. In its Disclaimer of Opinion, GAO writes, "Because of the government's serious systems, record keeping, documentation, and control deficiencies, amounts reported in the consolidated financial statements and related notes **do not provide a reliable source of information for decision-making by the government or the public."**[6] Simply put, Mr. Chairman, that means I can't do my job. According to this report, we are passing legislation and conducting oversight as well as a doctor performing surgery with a blindfold on.

We can't do our jobs if the Executive Branch can't give us the information we need. This year's Consolidated Financial Statements are an important step, not because we know how bad things are. We can't even know that. They are important because we know where we need the systems to get the information on just how bad things are. We all know things are bad. But until we get the information we need, we are a long way from doing anything constructive to fix them.

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2 Id, at 17.

3 Id, at 18.

4 Id, at 18.

5 Id, at 21.

6 Id, at 16.

Mr. HORN. I thank the gentleman and we had expected the majority leader, Mr. Armey of Texas, to be here. He's in a meeting of the Republican conference, so after Mr. Dodaro's opening statement, if the majority leader arrives, we will then have a temporary set-aside while he can address some of these issues.

We now have the first panel which begins with Gene Dodaro, Assistant Controller General of the U.S. General Accounting Office. He will be accompanied by Robert F. Dacey, Director of the Consolidated Audit and Computer Security Issues, Accounting and Information Management Division of GAO; Phillip Calder, Chief Accountant; and Linda Calbom, the Director of Civil Audits.

I think most of you know the routine.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all four witnesses have affirmed the oath.

Mr. Dodaro, it's always a pleasure to have you here. I'm going to ask you to start with one thing that isn't in your statement, and that is, if a citizen wants to get a copy of this report, is it going to be on GAO's worldwide web, and if so, let's get it in the record at this point.

Mr. DODARO. Yes, it is. It was posted to the GAO web site yesterday. So it is available to all the citizens through that page immediately, as we had it published.

Mr. HORN. Well, you can give us the WWW.-what?

Mr. DACEY. GAO.GOV, G-O-V.

Mr. HORN. "Gov" is after the GAO? Or first?

Mr. DACEY. GAO is first, WWW.GAO.GOV.

Mr. HORN. "GOV," very good. That's all they need to do?

Mr. DODARO. That's it.

Mr. HORN. Right. The marvels of technology. Please go ahead.

STATEMENTS OF GENE L. DODARO, ASSISTANT CONTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ROBERT F. DACEY, DIRECTOR, CONSOLIDATED AUDIT AND COMPUTER SECURITY ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, GAO; PHILLIP CALDER, CHIEF ACCOUNTANT, GAO; AND LINDA CALBOM, DIRECTOR, CIVIL AUDITS, GAO

Mr. DODARO. Good morning, Mr. Chairman, members of the subcommittee. In addition to the people at the table with me today, before I start my remarks, I'd like to recognize the senior management team of GAO that worked with the Inspectors General and the CFOs across the Government, in addition to OMB and Treasury, in carrying this out, this first-ever audit of the consolidated financial statements.

Behind me is the team of George Stalcup, Greg Kutz, Gary Engel, Lisa Jacobson, Gloria Jarman, and Jeff Steinhoff, who was a part of the original crafting of the CFO Act and providing service to the Congress, as well as Don Chapin, who as a former chief accountant at GAO and worked on these issues for a long period of time.

Mr. HORN. If the ones you named would stand, we'd like to thank you. So why don't you just stand, even if you have 4 feet of books in your lap. [Laughter.]

OK, fine. We thank you very much. You've all done a marvelous job over the years, and we've learned to trust you.

Mr. DODARO. I appreciate that recognition, Mr. Chairman. Also, I'd like to publicly thank all the Inspectors General and the CFOs throughout the Government who cooperated with us and OMB and Treasury in carrying out this historic first audit of the U.S. Government's financial statements.

Preparations for this type of improvement in Federal financial management have been underway for a number of years now. In the last few years we've put in place, in conjunction with OMB and Treasury, a set of accounting standards for the Federal Government. As you mentioned in your opening statement, we now have audits that are done of all the major departments and agencies. So, for the first time, the Federal Government is subjecting itself to the same type of rigors in fiscal discipline that have been in place in the private sector and State and local governments for a number of years. And it is beginning to produce some good results, as you noted. However, there is a lot of work that lies ahead in order for the Government to be able to pass the test of an audit, and what our report does is really highlight what those major challenges are.

Now, the report itself, as noted in your opening statements, itemizes all the various issues and deficiencies that need to be attended to, and we have a commitment from OMB and Treasury to move forward and address them.

What I'd like to do this morning in my opening remarks is just highlight the more serious areas that need attention and that need work. The first is the property, plant, equipment, operating materials, and supplies. These categories of equipment and computers, and the necessary tools to carry out Government activities, represent about two-thirds of the Government's assets, however, we found that hundreds of billions of dollars of the reported $1.2 trillion on the financial statements was not adequately supported by accounting or logistical records.

Now the biggest area here is at the Department of Defense. Defense accounts for roughly 80 percent of all these assets and one of the reasons that Defense has not been able to obtain a clean opinion on its financial statements, or for that matter, any opinion, so far, by the Department of Defense IG, is because of problems in this particular area, and in properly accounting for its assets. No major military service—Army, Air Force, Navy—has been able to receive anything other than a disclaimer of opinion. So this is an issue.

I also want to point out that it is an issue in civilian agencies, as well. There are problems in this area at FAA, and at the Forest Service, just to name a couple of areas. Our view is that until we can get proper accounting in place for these assets, the Federal Government is limited in its ability to make sure that they're adequately safeguarded, that agencies know their location, their condition, and that we're not ordering materials and supplies that we already have on hand, or incurring unnecessary costs to store items that are really not needed.

The second major category is in the loans and loans receivable area. The Federal Government is a guarantor of approximately $700 billion in loan guarantees, and the Federal Government needs to know what it's exposure is for defaults on those loans. Currently, there's not adequate historical data, or current information on loan portfolios necessary to make the estimates to make sure the liability, potentially, for the Government, for those loan guarantee portfolios, is adequately stated. And this is important so that we know the downstream costs of these programs.

Similar problems impede the ability to estimate the net receivables from direct loans, as well. In other words, how much money has the government loaned people directly, and what's the likely loss to be incurred through defaults on those loans as well? So that's another area. A number of credit agencies are working on this issue, but it's yet to be overcome.

A third major area I wanted to highlight is the environmental disposal liabilities area. This is one area in the financial statements that we know is understated. There's about $212 billion there, and that represents largely the amount of money reported by the energy department for cleaning up the nuclear weapons complex. We think that is a good number, but it does not include the costs of cleaning up ammunition, weapons systems, and a number of other disposal activities of the Department of Defense. So that number is clearly understated.

Also, as you mentioned in your opening statements, we're concerned about the amount of money, billions of dollars, in improper payments. And you highlighted those areas in your opening statements: Medicare, rent subsidies, Supplemental Security income. Our report also notes that we're concerned that in other areas, such as Medicaid, to name one, we don't have estimates yet, so the government does not really know the full range of payments that are being made that should not have been made, and we're going to be encouraging the administration to move forward in those areas.

Finally, the category I wanted to mention is a set of Government-wide accounting issues, and they really have three dimensions. No. 1, right now, the Treasury Department does not have in place a process to eliminate transactions among Federal agencies. There's a great deal of business that takes place within the Federal Government and as a result, there was close to $140 billion of gross transactions that could not be eliminated. Now they netted out to $12 billion, and that $12 billion was put in as a plug figure into the financial statements in order to make them balance, but Treasury needs to have a process in place to properly eliminate those transactions so that they can be reported properly.

The second major category or dimension of this is that Treasury is really operating as the banker for the Federal Government but the agency's records on cash disbursements and their fund balance with Treasury don't equal what Treasury has on their books. So there are a lot—billions of dollars—of differences between Treasury records and agency records that need to be properly reconciled.

The third category is that now that financial statements of individual departments and agencies are audited, that data needs to be consistent with the data Treasury uses to compile the Government-wide financial statements. And this year, several agencies were unable to provide assurance that that, in fact, happened. So there were hundreds of billions of dollars in adjustments that we suggested in order to correct that situation as well.

So those Governmentwide accounting issues need to be addressed in order to make sure that the financial statements can be reliable and that all the cost information is properly allocated to the Government's functional areas.

Now in addition to the problems that we noted on the reliability of the financial data presented in the statements, there are a couple of other control issues that I really wanted to underscore this morning. The first is in the computer security area. This is a very serious problem. Unauthorized access to data is a big issue, particularly given the interconnected nature of our computer systems. We have found serious problems across most of the Federal agencies that we've looked at. And this subjects, potentially, financial transactions to being erroneously manipulated, data being destroyed, and people having access to sensitive data that I'm sure the American public would not want—and is trusting their Government to protect.

In addition, we highlight the potential consequences of the year–2000 problem on the ability of the Government to properly record their transactions. This committee needs no introduction to that issue. I was here 2 weeks ago talking about the full range of implications there, but there's one point I wanted to underscore here again this morning. One is that we have existing weaknesses in computer security systems. Over the next couple of years, there's going to be intensive efforts under very severe time pressures to fix the year-2000 problem, and I'm concerned that we need to be vigilant to make sure that the security is not jeopardized or further compromised in order to make all these changes that need to be made for the year-2000 problem. So it's something we wanted to elevate to the attention of people because I can't think of any one particular time in history where so many systems will be repaired or replaced at one time. And, as you know, the time pressures are mounting in terms of the Government's ability to get this done.

Now, in conclusion, as we look toward the future, what do the prospects look like? We're encouraged by a number of things. No. 1, more Federal agencies are starting to get unqualified or clean opinions. We're making gradual progress in that area.

We also, this year, were able to get a good handle on some major parts of the Federal Government. GAO was able to give an unqualified opinion on the Bureau of Public Debt, so we know that the $3.8 trillion that the Government owes the public is properly stated, and that the interest on the debt is properly calculated. We're also able for the first time ever to give IRS a clean opinion on the total amount of revenue that has been collected. And we have other major agencies, as you noted, Defense, NASA, and Social Security receiving clean opinions.

So we have some good progress to build upon, but there are some other big parts of the Government that just aren't there yet and it's going to take a concerted effort. I'm also encouraged by the fact that there's been a commitment in the President's budget in terms of priority management objectives, to get clean opinions on all the agencies. I note some of the agencies have included getting a clean opinion as a performance measure under the Results Act, which is a good thing. And a number of the performance measures themselves are being derived from the financial statements, so that's another good development as well. And there's a commitment to get a clean opinion on a Governmentwide statement.

It won't be easy, but I want to close my remarks by assuring the Congress that we're committed at GAO to continue to work with the executive branch in order to bring about the reforms that were intended by the CFO Act, which were to get clean opinions, but more importantly than that, to have complete reliable information throughout the year in order to manage the Government's activities and give the American people the type of accountability and confidence in Government that they really deserve.

Thank you very much, Mr. Chairman. We would be happy to answer any questions.

[The prepared statement of Mr. Dodaro follows:]

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the results of our audit of the United States government's consolidated financial statements. The Chief Financial Officers (CFO) Act, as expanded by the Government Management Reform Act, requires the Secretary of the Treasury, in cooperation with the Director of the Office of Management and Budget (OMB), to annually prepare these statements, beginning with those for fiscal year 1997, and GAO is required to audit them. Yesterday, the first consolidated financial statements for the U.S. government, along with our report, were submitted to the Congress and the President by the statutory deadline.

The preparation of this historic document is the latest product of a series of reforms with the goal of producing much needed improvements in the federal government's financial management. These efforts have included the development and issuance of a new set of generally accepted accounting standards for the federal government.[1]

In 1990, the CFO Act established a pilot program under which a few agencies began preparing and auditing financial statements. Following the successful pilot program, each of the government's 24 largest departments and agencies was statutorily required to annually produce audited financial statements using the new accounting standards, beginning with fiscal year 1996.

These reforms now subject the federal government to the same fiscal discipline imposed for years on the private sector and state and local governments. This discipline is needed to correct long-standing serious weaknesses in financial management systems, controls, and reporting practices. Considerable effort is underway across government to make needed improvements and progress is being made, but it will take concerted, sustained attention to rectify years of inattention.

The most serious challenges are framed by the results of our audit of the consolidated financial statements of the U.S. government for fiscal year 1997. In summary, significant financial systems weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, prevented the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the reliability of the consolidated financial statements and much of the underlying financial information. They

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[1]Federal accounting standards are developed and recommended by the Federal Accounting Standards Advisory Board, which was established in October 1990 by the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General.

also affect the government's ability to accurately measure the full cost and financial performance of programs and effectively and efficiently manage its operations. Major problems included the federal government's inability to

-- properly account for and report billions of dollars of property, equipment, materials, and supplies;

-- properly estimate the cost of most federal credit programs and the related loans receivable and loan guarantee liabilities;

-- estimate and report material amounts of environmental and disposal liabilities and related costs;

-- determine the proper amount of various reported liabilities, including postretirement health benefits for military and federal civilian employees, veterans compensation benefits, accounts payable, and other liabilities;

-- accurately report major portions of the net costs of government operations;

-- determine the full extent of improper payments that occur in major programs and that are estimated to involve billions of dollars annually;

-- properly account for billions of dollars of basic transactions, especially those between governmental entities;

-- ensure that the information in the consolidated financial statements is consistent with agencies' financial statements;

-- ensure that all disbursements are properly recorded; and

-- effectively reconcile the change in net position reported in the financial statements with budget results.

Such deficiencies prevented us from being able to form an opinion on the reliability of the consolidated financial statements. They are the result of widespread material internal control and financial systems weaknesses that significantly impair the federal government's ability to adequately safeguard assets, ensure proper recording of transactions, and ensure compliance with laws and regulations. Additionally, (1) serious computer control weaknesses expose the government's financial information to inappropriate disclosure, destruction, modification, or fraud and (2) material control weaknesses affect the government's tax collection activities.

Our audit of the federal government's consolidated financial statements and the Inspectors General (IG) audits of agencies' financial statements have resulted in an identification and analysis of deficiencies in the government's recordkeeping and control systems and recommendations to correct them. Fixing these problems represents a significant challenge because of the size and complexity of the federal government and the discipline needed to comply with new accounting and reporting requirements. Several individual agencies that have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them.

With a concerted effort, the federal government, as a whole, can continue to make progress toward ensuring full accountability and generating reliable information on a regular basis. Annual financial statement audits are essential to ensuring the effectiveness of the improvements now underway, and ultimately, to producing the reliable and complete information needed by decisionmakers and the public to evaluate the government's financial performance. They are also central to helping the government implement broader management reforms called for by the Government Performance and Results Act.

The following sections outline (1) our disclaimer of opinion on the government's fiscal year 1997 consolidated financial statements, (2) internal controls weaknesses, and (3) serious difficulties complying with financial systems requirements. They also present information on (1) the Year 2000 computing problem, (2) issues affecting the government's long-term financial condition, and (3) actions underway to improve financial reporting across the government.

DISCLAIMER OF OPINION

Overall, because we were unable to determine the reliability of significant portions of the government's fiscal year 1997 consolidated financial statements, we were unable to express an opinion on them. However, we were able to determine that amounts reported for environmental and disposal liabilities and liabilities for veterans compensation benefits are understated by material amounts.

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

The following sections describe material deficiencies we identified and discuss their effect on the financial statements and the management of government operations.

Property, Plant and Equipment and Inventories and Related Property

The federal government--one of the world's largest holders of physical assets--does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than $1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records. These include (1) operating materials and supplies comprised largely of ammunition, defense repairable items (such as navigational computers, landing gear, and transmissions), and other military supplies and (2) buildings, military equipment, and various government-owned assets in the hands of private sector contractors.

Because the government does not have complete and reliable information to support its asset holdings, it could not satisfactorily verify the existence of all reported assets, substantiate the amounts at which they were valued, or determine whether all of its assets were included in its financial statements. For example, certain recorded military property had, in fact, been sold or disposed of in prior years--or could not be located--and an estimated $9 billion of known military operating materials and supplies were not reported. These problems impair the government's ability to (1) know the location and condition of all its assets, including those used for military deployment, (2) safeguard them from physical deterioration, theft, or loss, (3) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (4) determine the full costs of government programs that use the assets.

Loans Receivable and Loan Guarantee Liabilities

Most federal credit agencies responsible for federal lending programs were unable to properly report the cost of these programs. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, veterans' mortgages, and student loans. As of the end of fiscal year 1997, the government reported $156 billion of loans receivable and $37 billion of liabilities for estimated losses on defaulted guaranteed loans. However, the net loan amounts expected to be collected and guarantee amounts expected to be paid could not be reasonably estimated because of a lack of historical data or other evidence. In addition, some agencies did not have adequate information to support the validity of their outstanding direct loans or to track the specific loans that they have an obligation to guarantee.

Until federal credit agencies correct these serious data deficiencies, information supplied by them about the cost of their credit programs, including information to support annual budget requests for these programs, should be used with caution in making future budgetary decisions, managing program costs, and measuring the performance of credit activities.

Environmental Liabilities

Liabilities for disposal of hazardous waste and remediation of environmental contamination, reported at $212 billion, were materially understated primarily because an estimate has not been developed for major weapons systems, such as aircraft, missiles, ships and submarines, and for ammunition. Properly stating these liabilities could assist in determining priorities for cleanup activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities.

Liabilities

The systems and data were not available to accurately estimate significant portions of the more than $2.2 trillion reported as federal employee and veterans benefits liabilities. For example, to estimate the $218 billion reported as military postretirement health benefit liabilities, the government used unaudited budget information because the necessary cost data were not available. Also, the federal government cannot provide adequate assurance about the reliability of historical claim information at the insurance carrier-level used to estimate the $159 billion reported for civilian postretirement health benefit liabilities.

Additionally, the estimated liability for veterans compensation benefits is materially understated because it does not include estimates for anticipated changes in disability ratings and for incurred claims not yet reported. In addition, some agencies do not maintain adequate records and controls or have systems to ensure the accuracy and completeness of data used to calculate estimates of a reported $98 billion of accounts payable and a reported $169 billion of other liabilities such as those for litigation.

These problems significantly affect the determination of the full cost of the government's current operations, as well as the extent of actual liabilities. Further, commitments and contingencies were not properly reported because many amounts represent the maximum risk exposure rather than the amount of loss that is reasonably possible and certain commitments are not reported.

Costs of Government Operations

The government was unable to support significant portions of the more than $1.6 trillion reported as the total net costs of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective reconciliations, as discussed below, also affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost categories reported in the Statement of Net Cost and in the subfunction detail following the statement were properly classified. Without accurate cost information, the federal government is limited in its ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required.

The government is also unable to determine the full extent of improper payments--that is, payments made for other than valid, authorized purposes. In this regard, estimates of improper payments in major federal programs, such as Medicare, total in the billions of dollars annually. The full extent of such payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs. The reasons for improper payments range from mistakes to fraud and abuse. Such payments are likely to continue until agencies implement better systems and controls.

Unreconciled Transactions

To make the consolidated financial statements balance, Treasury recorded a net $12 billion item on the Statement of Changes in Net Position, which it labeled unreconciled transactions. This out-of-balance amount is the net of more than $100 billion of unreconciled transactions--both positive and negative amounts--which Treasury attributes to the government's inability to properly identify and eliminate transactions between federal government entities and to agency adjustments that affected net position.

Agencies' accounts can be out of balance with each other, for example, when one or the other of the affected agencies does not properly record a transaction with another agency or the agencies record the transactions in different time periods. These out-of-balance conditions can be detected and corrected by instituting procedures for reconciling transactions between agencies. Generally, such reconciliations are not performed. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

Preparation of Consolidated Financial Statements

The federal government cannot ensure that the information in the consolidated financial statements is consistent with agency financial statements. Treasury relies on agencies to submit data needed to prepare the federal government's consolidated financial statements. Such data consists of approximately 2,000 individual reporting components, each having many account balances. However, several agencies were unable to provide assurance that amounts submitted to Treasury agreed with their agency financial statements. In addition, many agencies needed to make significant subsequent adjustments to their submissions in an effort to properly classify amounts in the consolidated financial statements.

We found further misstatements, which Treasury corrected, totalling several hundred billion dollars in agency-submitted information primarily because (1) agencies submitted incorrectly coded financial data that contributed to the unreconciled transactions described above, (2) agencies recorded similar transactions in different general ledger accounts, and (3) certain amounts were materially misallocated to net cost categories.

These problems are compounded by the substantial volume of information submitted, limitations in the federal government's current general ledger account structure, and the significant amount of other information that Treasury must gather to prepare the consolidated financial statements. As a result, additional misstatements in the government's consolidated financial statements could exist.

Cash Disbursement Activity

Several major agencies are not effectively reconciling disbursements. These reconciliations are a key control--similar in concept to individuals reconciling personal checkbooks with a bank's records each month. However, there were (1) billions of dollars of unresolved gross differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1997 and (2) large amounts of unresolved differences arbitrarily written off by some agencies without adequately determining whether their records may, in fact, have been correct. As a result, the government is unable to ensure that all disbursements are properly recorded.

Reconciling the Change In Net Position With Budget Results

The government did not have a process to obtain information to effectively reconcile the reported change in net position of

$3 billion and the reported budget deficit of $22 billion. The reconciling items comprising the difference are typically the result of timing differences in the recognition and measurement of revenue and costs. Under budgetary accounting, the budget deficit reflects outlays and receipts that generally are measured on a cash basis. For financial statement reporting purposes, costs are reported when incurred rather than when paid. Federal decisionmakers use budgetary accounting to control the use of funds and for fiscal planning. Once the federal government produces reliable consolidated financial statements, an effective reconciliation would provide additional assurance of the reliability of budget results.

MATERIAL CONTROL WEAKNESSES

We found pervasive material weaknesses[2] in internal controls across government that contribute to these deficiencies. These weaknesses, such as the lack of effective reconciliations and poorly designed systems, result in ineffective controls over (1) safeguarding the federal government's assets from unauthorized acquisition, use, or disposition, (2) ensuring that transactions are executed in accordance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) ensuring the reliability of financial statements.

We also found that widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many material deficiencies discussed above. Material control weaknesses also affect the government's tax collection activities.

Computer Control Weaknesses

Widespread computer control weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant information security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. In today's highly computerized and interconnected environment, such

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[2]A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that 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.

weaknesses are vulnerable to exploitation by outside intruders as well as authorized users with malicious intent.

The consequences of computer control weaknesses could be devastating and costly--for instance, placing billions of dollars of payments and collections at risk of fraud and impairing military operations. In addition to these potential consequences at Treasury and Defense, identified weaknesses at agencies such as the Department of Health and Human Service's Health Care Financing Administration and the Social Security Administration place sensitive medical and other personal records at risk of disclosure.

Because computer control weaknesses are pervasive across government, in February 1997, we added information security to our list of federal high-risk areas.[3] The problem persists, in large part, because agency managers have not fully instituted a framework for assessing risk and ensuring that necessary policies and controls are in place and remain effective on an ongoing basis. Over the past 2 years, we and the IGs have issued more than 70 reports that identify computer control weaknesses in the federal government and made recommendations to address them.

Tax Collection Activities

The federal government has material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue.[4] This situation requires extensive reliance on ad hoc programming and analysis and material audit adjustments to prepare basic financial information. For example, the government currently does not obtain information necessary to identify tax collections by every type of tax at the time of collection. As a result, the government cannot separately report revenue for three of the four largest revenue sources--Social Security, Hospital Insurance, and individual income taxes. Because of this, the government had to report these three tax types in the same line item on the Consolidated Statement of Changes in Net Position. Additionally, excise tax revenues are distributed to the relevant trust funds based on assessments rather than, as required by the Internal Revenue Code, on collections.

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[3]High-Risk Series: An Overview (GAO/HR-97-1, February 1997) and High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

[4]Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

Serious weaknesses also affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.[5] The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness, for example, has resulted in the government pursuing and collecting, from individual taxpayers, taxes that had already been paid. Additionally, the federal government is vulnerable to loss of tax revenue due to weaknesses in controls over disbursements for tax refunds. The government does not perform fundamental verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Consequently, it does not have effective controls to prevent the inappropriate payment of refunds, increasing its exposure to lost revenue.

FINANCIAL SYSTEMS REQUIREMENTS GENERALLY NOT MET

The Federal Financial Management Improvement Act of 1996 requires auditors performing financial audits under the expanded CFO Act 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. We reported in October 1997[6] that prior audit results and agency self-reporting all point to significant challenges that agencies must meet to fully implement these requirements. The significant financial management deficiencies discussed throughout this report underscore the challenge.

The majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and cannot provide reliable financial information for managing government operations and holding managers accountable. Auditors' reports for fiscal year 1997 agency financial audits are disclosing the continuing poor shape in which agencies find their financial systems. As of the date of our audit report, only four agency auditors have reported that their agency's financial systems comply with the act's requirements.

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

[6]Financial Management: Implementation of the Federal Financial Management Improvement Act of 1996 (GAO/AIMD-98-1, October 1, 1997).

YEAR 2000 COMPUTING CRISIS

The Year 2000 computing crisis is the most sweeping and urgent information technology challenge facing pubic and private section organizations.[7] In recent testimony[8] before the Subcommittee, we discussed the need for strong leadership and effective public/private cooperation to avoid major disruptions due to the Year 2000 computing crisis. The federal government is extremely vulnerable due to its widespread dependence on computer systems to deliver vital public services and to carry out financial operations, such as processing financial transactions, reporting financial information, controlling property, and collecting revenue. While some progress has occurred in addressing the Year 2000 problem, a great deal of additional effort is required to prevent serious disruptions in government operations and in financial transactions and reporting.

This challenge is made more difficult by the age and poor documentation of the government's existing systems and its lackluster track record in modernizing systems to deliver expected improvements and meet promised deadlines. Consequently, we surfaced the Year 2000 computing crisis as a high-risk area across government in February 1997.

In the past year, we have issued over 20 reports outlining actions underway in a wide range of federal activities to address this challenge and providing numerous recommendations for additional improvements needed. The President recently created a Council on Year 2000 Conversion, led by an Assistant to the President, to oversee federal agencies' Year 2000 efforts, speak for the United States in national and international forums, and coordinate with governments at all levels, as well as with the private sector. We will continue to monitor this situation and make needed recommendations.

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[7]For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data storage and reduce operating costs. In this format, however, 2000 is indistinguishable from 1900 because both are represented as "00." As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

[8]Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-101, March 18, 1998).

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

When the government is able to produce them, reliable consolidated financial statements will be a valuable tool for analyzing the government's financial condition. They will also help inform budget deliberations by providing additional information beyond that provided in the budget on the long-term cost implications for a wide range of government programs. The largely cash-based budget and the financial statements offer different perspectives which, when combined, can provide a fuller view of the costs of agency programs and of the government's commitments.

A view of the long-term sustainability of fiscal policies can also be helpful to decisionmakers considering the government's financial position and making decisions about resource allocation. Such a picture requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the implied commitments of social insurance programs--such as Social Security and Medicare--must be considered in addition to those items that are quantified in the financial statements. For example, if the combined Social Security trust funds' disbursements exceed receipts, as currently estimated to occur in 2012, the government's financing needs will increase. Since 1992, in a series of long-term simulations, we have analyzed various fiscal policy alternatives and their long-term sustainability.[9]

FINANCIAL MANAGEMENT IMPROVEMENTS UNDERWAY

Several individual agencies that have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them. For example, we conducted audits of IRS' financial statements since fiscal year 1992. During our first audits, we identified serious problems and were unable to give an opinion on IRS' financial statements. IRS was committed to resolving the problems, and we were able to express an unqualified opinion on its custodial financial statements for fiscal year 1997. These financial statements reported over $1.6 trillion of tax revenue, $142 billion of tax refunds, and $28 billion of net federal taxes receivable.[10]

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[9]The most recent of these reports are Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998) and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

[10]Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

In another case at Treasury, we audited and expressed an unqualified opinion on the Schedule of Federal Debt Managed by Treasury's Bureau of the Public Debt.[11] This schedule reported (1) $3.8 trillion of federal debt held by the public comprising individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks, (2) $1.6 trillion of federal debt held by federal entities, such as the Social Security trust funds, and (3) $246 billion of interest on federal debt held by the public.

At the completion of our field work, several agencies have received unqualified opinions on fiscal year 1997 financial statements. These agencies are the:

-- Social Security Administration.
-- National Aeronautics and Space Administration.
-- Nuclear Regulatory Commission.
-- Department of Energy.
-- General Services Administration.
-- Department of Labor.
-- Small Business Administration.
-- Environmental Protection Agency.

The executive branch recognizes the extent and severity of the financial management deficiencies discussed in this report and that addressing them will require concerted improvement efforts across government. Financial management has been designated one of the President's priority management objectives, with the goal of having performance and cost information in a timely, informative, and accurate way, consistent with federal accounting standards. Also, the administration has made a commitment to complete audits and gain unqualified opinions for all CFO Act agencies and the government as a whole.

To help achieve this goal, strategies are being established involving specific agencies. For example, plans at the Department of Defense include completing a new accounting systems architecture, reviewing inventory accounting processes, and developing a departmentwide property accountability system. Treasury and OMB are developing plans to improve the accuracy and timeliness of governmentwide accounting and reporting.

OMB is also working with individual agencies to address problems precluding unqualified audit opinions, which will require the active involvement of individual agency IGs as well. We will continue to focus on financial systems and internal control

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[11] Financial Audit: Examination of the Bureau of the Public Debt's Fiscal Year 1997 Schedule of Federal Debt (GAO/AIMD-98-65, February 27, 1998).

deficiencies at particular agencies. For example, we have issued a series of reports[12] on the factors to be considered and the data that must be available to meet accounting standards for Defense's environmental and disposal liabilities. Also, we plan to further evaluate Defense's property and logistical systems to recommend additional corrective actions to address weaknesses in accounting for major asset categories on the financial statements. We are also working with the major credit agencies to improve reporting of loans and loan guarantees.

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

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

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

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[12] Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997), Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997), Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997), and Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

Mr. HORN. I thank you for your usual outstanding presentation here, without a note in front of you, I might add. And we're going to need your chair temporarily, Mr. Assistant Controller General, for the majority leader. So, Gene, take a seat there where you can relax, and we're going to have the majority leader of the U.S. House of Representatives come forward for testimony on this.

Let me say, as Dr. Armey comes here, he's not only a Ph.D. and a former professor, a Ph.D. in economics, but he has been the real leader in terms of the Congress reviewing the Results Act strategic plans, in terms of the performance indicators that are going to grow out of these plans, and I might say, from my study of Congress, for 200 years—not for me, but for the period—no majority leader in history has ever taken as much of an interest in getting results out of the executive branch as this majority leader. So, Mr. Armey of Texas, we're delighted to have you.

Mr. SESSIONS. Mr. Chairman, I'd ask for a point of personal privilege.

Mr. HORN. You mean two Texans shouldn't be in the room at the same time. [Laughter.]

Mr. SESSIONS. Mr. Chairman, I would like to state that—adding on to what you've said, that I believe that Congressman Armey not only has consistently been but is the greatest Congressman in the history of the U.S. Congress. And I'm very proud to have him as our majority leader because he is worried about things that people who sit around their family's tables talk about. That's what he talks about, daily, that we should be concerned with here in Congress. And when we're talking about people and problems, he believes there's no problem in this country that cannot be solved, but it takes people who can work hard on that and can be honest and tell the truth about it, and that's our Dick Armey. Thank you.

Mr. HORN. You obviously are in a friendly climate here.

STATEMENT OF HON. RICHARD ARMEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND MAJORITY LEADER OF THE U.S. HOUSE OF REPRESENTATIVES

Mr. ARMEY. Thank you, Mr. Horn, and thank you, Mr. Sessions. Let me thank this committee for the hard work you've already invested in this subject and for holding these hearings. Let me thank the General Accounting Office for the enormous effort they've put forth with over 300 people that have been working on this.

I was listening to Gene Dodaro, from GAO, and thinking about my own daughter, who is an internal auditor with a fairly large corporation in Dallas. It just causes me to want to begin my statements by saying, pity the poor auditor. Wherever he or she shows up, they are inevitably the skunk at the garden party. Nobody wants to see them there. They're going to be a bother, they're going to be trouble, they're going to be accurately measuring what you do and how you do it, and what you've done with the resources, and hold you accountable.

And it's not a pleasant job, but, you know, the interesting thing about it is it's a job that is done, if only at the most intuitive levels, by all of us. It's a job that we recognize, again, if only intuitively, must need to be done. We do it, for example, in the casual business of sitting around the kitchen table examining our budgets, and wondering, how did we do, are we doing well, have we met our priorities, do we need to reallocate, where was the waste and the inefficiency?

My wife and I do that and one of the things that's interesting about it is that in this kind of relationship, we've become each other's auditors. I couldn't help but reflect that I'll be talking in a little detail later about some of the problems you have when things get lost—my auditor, that is, my wife, Susan, caught up with me just last week when she recalled that some time ago I had bought a small and portable $500 bass boat which I had subsequently lent to my sons, which they subsequently lent to someone else, and we now realize that it has been subsequently lost. My auditor held me accountable for it.

And as I go home at recess, one of the things that I will do, in addition to working with my constituents, is comply with the results of the audit and find that little bass boat. These things must be done. Well that may be a whole new example of the way we conduct this process rather informally among ourselves.

As, of course, enterprises become larger and more sophisticated, more complex, then auditing becomes more of a formal and more of a rigorous process following defined procedures. We understood the need for auditing when we assumed the majority of Congress in January 1995, and one of the first things we did was the first ever audit of Congress, the House of Representatives.

We were amazed at the state of disorder we found. It took us a long time, of course, to fully comprehend what all needed to be corrected, and how we might best correct things, but at this point, we are now able to operate the legislative branch of Government at $150 million a year less than it was operating before we took it over.

So the first thing that I would say to each and every one of these agencies that we will deal with is, if you feel like the House is beleaguering you, at least be consoled by the fact we started with ourselves some 2½ years ago. And we are trying to find, and continuing to find each day, better opportunities to comply with the audit.

The first time ever audit of the Federal Government has been an enormous task, and it has been, I suppose, a discouraging set of discoveries. On the other hand, if even in our own families we were to go for any extended period of time without these kitchen table audits, we would probably find things in a bit of a mess, too. So we shouldn't be alarmed, and I don't think we ought to be discouraged. I think, in fact, we ought to understand that these discoveries, this information, this good work by the General Accounting Office, brings clarity of understanding to what it is we have, how are we effectively using our resources, and how can we improve.

So I would hope that my short remarks today would be a message of encouragement to everybody. The auditing we know is a painful process, but it's a necessary process and can be a very, very beneficial process.

I am struck by some of the discoveries we had. The fact that we end up with a $12 billion plug in the budget just to make the results come out. Sometimes in commercial enterprise that's called owner's equity. But you have to make your assets equal your debits on paper as they do in fact in real life. But the more you can account that, and the more you can pare such a plug as this down to a smaller and smaller number, the more you will have a more whole and complete accounting.

I was also struck by some of the things we discovered, what we do have, and some of the things we discovered of what we do not have. Pete Sessions has learned that the Pentagon owns a 200-year supply of raincoats. And, you know, my first reaction is, well, everybody thinks they ought to have a rainy day fund; maybe this is the Pentagon version of that. I don't know. But I don't know how much we need a 200-year supply of raincoats and perhaps excessive inventories, if properly understood, and properly controlled, might be able to give us some of the cost efficiencies that our defense actually, literally needs.

So, again, I would see this discovery as information obtained that will help the military to be more effective and, if you'll pardon the pun, get better bang for their buck on the field.

The things that I found that were lost, apparently, were some solace to me. And I'll be happy to point these out to my wife when I go home and she finds me defending my $500 portable bass boat. Someplace in the Government we have lost two utility boats valued at $174,000 each; 2 large harbor tug boats, valued at $875,000 each; one floating crane valued at $468,000—you know, one of the things that amazes me, and I'm always impressed at the heights that are attainable by the Government, how can you lose a crane that size? You would think somebody would notice it somewhere. But we also have 15 aircraft engines, including the two F–18 engines valued at $4 million each; and then one—and sometimes these things, I might say, can be distressing too, an Avenger missile launcher valued at a $1 million.

I think we have a picture of this missile launcher. Now that's not your average recreational vehicle. I'm going to just bet that somebody in America has seen this, and as a citizen's duty, might want to report to us where this is being operated. Certainly not on the deserts of southern California, Mr. Chairman, but it's conceivable it could show up in Texas.

At any rate, while I think we ought to keep our sense of humor, we should also appreciate that this is an audit that is comprehensive, complete, and rigorous, and a first, unique event in the history of so many people in this government. The discipline of audits that are known to be essential to the effective operation of any enterprise in the private sector. We should know that this audit has purposes discovering, acquiring information, coordinating information, and clarifying of knowledge about ourselves in the performance of our duty, that if taken with a good sense of humor and a good appreciation for one another and our foibles, because each and every one of us have them. I'm sure that I've just created before us now the most famous lost portable bass boat in America.

But, let's keep our sense of humor while at the same time we retain a disciplined respect for the process, for the need to conduct the process, and a healthy optimism, and a great expectation for what results we can obtain on behalf of the American people as we complete this.

Now, one final point. There is a natural resistance to change, and to disciplined change, and especially when it is somebody like an auditor, from the outside, showing up with their good advice. And I'm fond of pointing out to people, I don't need your good advice, I can get into trouble on my own.

There will be, I think, a resistance. We are asking the Government to take on—and each and every agency—a new discipline, a new self-examination, a new acceptance of criticism, and new a resolve to correct mistakes, errors, and misallocations of resources. We need to approach that with an understanding that this is not easier for somebody in an agency down the street than it is for you and for me in our own personal lives or in the operation of the congressional office, or in the operation of the committee. But these things are necessary, and they're part of our duty and responsibility to the taxpayers.

I know that in Washington, it is popular to encourage people by using the greatest encourager of all, the expression, you owe it to yourself. But in this case, that is not where the debt lies. We owe it to the American people, and to the service that Government must be in the lives of the American people—to accept this rigor, accept this responsibility, accept this duty, and see the job through.

So, once again, let me thank you, Mr. Horn, for your work in the committee. Your discovery has already been very important and very encouraging to other congressional committees and agencies. And let me thank the GAO, probably the largest and most misbegotten group of skunks at garden parties in America today, but they're doing a good job, and we love them. So thank you.

[The prepared statement of Hon. Richard Armey follows:]

Statement of Dick Armey, House Majority Leader
April 1, 1998

First Taxpayer Scorecard on the Government's Financial Accountability
Is it an April Fool?

With the April 15 deadline approaching, many Americans are now finishing their tax returns to send to Washington. They've done the hard work, and they've kept track of their spending and receipts. One would expect the government itself would do the same.

The sad fact is that this is not the case. The government has been spending the hard-earned money of American people without adequate accountability.

Although it may be April Fool's Day, what we have found in this first government-wide audit is no joking matter.

Yesterday, the federal government issued the very first financial audit of the federal government. I call it the first *taxpayer scorecard on the government's financial accountability*. The data found in the financial reports was not reliable enough to allow GAO to even render an opinion on the statements.

Remarkably, Congress found out, through our efforts to implement the Government Performance and Results Act, that the government has precious little information on whether existing programs are *effective* in achieving the intended results or not. Now, we know there is little credible *cost* information on the operation of the government.

What would the IRS do to a business or taxpayer if the books looked like this? IRS agents would camp out in their home or office and count ever penny to make sure that Uncle Sam got its fair share. They would put liens on property; they'd repossess items; they'd prosecute. They might even lock the doors and throw the business owners in jail, for negligence, embezzlement or worse. A large private company could find that the SEC would prevent them from issuing any securities if their audit revealed similar poor financial information. States and local governments could risk having their federal funding curtailed if they didn't provide Washington with a clean audit.

When Republicans became the majority party for the first time in 40 years in 1994, we made a promise. We promised the American public that we would change the way Washington works and thinks. And with each step we take -- we get closer to a goal of a smarter, smaller, more common-sense government.

Among the most troubling findings to me of the first ever government-wide audit:

The $12 Billion Plug

Large corporations with many subsidiaries must coordinate their financial statements. And the $1.9 trillion operation of our federal government must show how the Cabinet level agencies all fit together. However, the federal government could not get the financial numbers to add up. The audit shows that they have inserted a $12 billion "plug" to fix their unreconciled transactions between federal agencies.

The Missing Inventory

The first ever audit has disclosed that the U.S. Government owns more than $1.2 trillion in assets, bought with taxpayers' dollars.

As my colleague from Texas, Pete Sessions, has learned – the Pentagon, among other things, owns a 200 year supply of raincoats. They sure know how to keep track of raincoats, but they have problems keeping track of expensive equipment like those that Senator Thompson identified yesterday:

- two utility boats values at $174,000 each;
- two large Harbor Tug boats valued at $875,000 each;
- one floating crane valued at $468,000;
- 15 aircraft engines including two F-18 engines valued at $4 million each; and
- one Avenger Missile Launcher valued at $1 million. (poster shown)

And this is just what the auditors were actually able to discover.

Summary

We need a government that is accountable to taxpayers. If we are ever to assure the public that the government is spending their hard-earned dollars wisely, we must have credible cost information and credible performance measures that make sense.

That's why this Congress is focusing so heavily on obtaining systematic, credible information about the operation of the federal government. Throughout all the congressional committees, a watchful public will see this Congress using the Results Act implementation to find out where federal programs and activities are going, how they will get there and setting up measurement to keep them on track. We need honest cost information about federal activities too.

The federal government makes decisions daily about spending $1.9 trillion of taxpayer dollars; Washington manages a $850 billion loan portfolio. Americans need to have confidence that Washington is not wasting their money.

We need to have honest information to make smarter decisions about federal programs – what's working, what's wasted.

Today's news may be sobering. It should be a wake up call for all of us, but especially for the Administration who is responsible for setting out a plan of immediate, corrective action. The Congress now more fully appreciates the hard work ahead of us. There will be consequences for poor management or for waste and fraud that is identifiable. The Results Caucus Members, spearheaded by Pete Sessions is posed to work program by program, problem by problem to seek solutions and save taxpayer dollars. Over time, and with focused attention, this Congress will make Washington work for the American taxpayers, and not have American taxpayers working for Washington!

Mr. HORN. Thank you very much for your testimony. I remember, as a 10-year-old, seeing something like that, without the missile bit. They used to call it the duck. And I'm thinking maybe if you got one of those old ducks that you'd have a very good bass boat, so, good luck.

Now, we will go to the second panel, and Mr. Dodaro can have a rest for a while, and then we'll ask him to come back after the second panel is concluded. And that is the panel from the administration. We have today Mr. Edward DeSeve, the Controller and Acting Deputy Director for Management of the Office of Management and Budget, which is the President's essential organization to manage the executive branch of the Government, on his behalf. And Mr. Gerald Murphy, the Senior Advisor to the Under Secretary for Domestic Finance in the Department of the Treasury, and he's accompanied by the Honorable John D. Hawke, Under Secretary for Domestic Finance of the Department of the Treasury.

Gentlemen, you know the routine here, also.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all three witnesses have affirmed the oath.

And please proceed in any order you'd like. I have down Mr. DeSeve, but if the Under Secretary would like to speak—we'll start with Mr. DeSeve who has been managing this process within the executive branch. Thank you.

STATEMENTS OF EDWARD DeSEVE, CONTROLLER AND ACTING DEPUTY DIRECTOR FOR MANAGEMENT, OFFICE OF MANAGEMENT AND BUDGET; GERALD MURPHY, SENIOR ADVISOR TO THE UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY; AND JOHN D. HAWKE, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. DESEVE. Mr. Chairman, thank you very much. I want to thank you, and I want to thank the Members, and I especially want to thank Mr. Armey. I thought his remarks were statesmanlike and right to the point; very well put.

I'm here today to discuss the results of the first ever audit of the Federal Government's consolidated financial statements. We welcome the Congress's interest in this process and look forward to your support as we continue to work together to correct the decades-old weaknesses identified by the General Accounting Office in its audit.

Last night I characterized this as cleaning out a closet that was 200 years old, and finding things in there that really dismayed you, and things that really needed a lot of attention. And that's the way that I feel about this, and that's the way we're approaching this.

The Clinton administration has aggressively advocated accountability, including financial statements audits, since the beginning of this administration. In September 1993, the National Performance Review recommended that the Federal Government prepare an annual consolidated audited financial report. In addition, the NPR supported the creation of a comprehensive set of basic accounting standards for the Federal Government. In the latter instance, NPR was critical of the amount of time it was taking to put accounting standards in place. The administration, in agreeing with the NPR recommendations, committed to have a basic set of accounting standards in place, and we've met that commitment.

In 1994, the administration strongly supported, and the President eagerly signed, the Government Management and Reform Act to require all major agencies and the Government as a whole to prepare and have audited financial statements. We did this to create a clear basis for addressing accumulated problems in financial and asset management.

We knew from the beginning that this was a massive undertaking and could not be completed in the first year, nor in the second year. For several agencies, it will take many years to gain an unqualified opinion, but we expect to see improvements each year in accuracy, reliability, and, Mr. Chairman, in timeliness, of agency financial statements. We've seen that progress.

I have a simpler chart, to some extent, than the one you used, but I think it just, as of a point in time, it has the same kinds of numbers that you had. In 1994, only 33 percent of agencies were audited. Now, in 1997, 96 percent, 23 out of 24, are fully audited. One, FEMA, is partially audited. So there's progress in just getting the audits done. And, again, 18 percent, 4 agencies, had clean statements in 1994. Now, with a couple of the incompletes that you appropriately put on your chart—and I applaud your scorecard. I think it was well done. I think it was thoughtfully done. Forty-six percent of the agencies, with the two we expect—and we could be wrong, it could be only one of the two, but we think there will be two more—will be audited.

Is that good? No. We need to do better. We all need to do better. We want to show progress each year.

The first steps toward implementing the Government Management and Reform Act for agency audits, for fiscal year 1996, and a Governmentwide audit for fiscal year 1997, were to put in place policies and procedures to issue accounting standards. As a founding member of the Federal Accounting Standards Advisory Board, OMB worked with Treasury, other executive branch agencies, GAO, CBO, and private sector representatives, in order to create the standards from scratch.

According to the current, well-recognized chairman of FASAB, the Federal Accounting Standards Advisory Board, these standards were produced quickly compared to other standards-setting bodies, and encompass a broader range of issues than those bodies are used to dealing with.

Recognizing that we did not expect to receive an unqualified opinion on the first consolidated financial statements, the President's fiscal year 1999 budget includes a target for having a qualified audit opinion on the Governmentwide statements by fiscal year 1999. In addition, 23 of 24 agencies target timely, clean opinions for fiscal year 2000.

[Chart shown.]

Mr. DESEVE. We've been tracking these in the financial management community since 1995. This is the executive summary of the Federal Financial Management Status Report and 5-year plan. One of the things that we want to track are not just the agencies themselves. In many cases, that hides even more important components.

For example, in the Defense Department, the Army, Navy, Air Force, and so on, are components. The IRS is a component. So we track those as well.

We also track Government corporations. There are large Government corporations out there. They've had a longer history, and as a result, are more successful. On average, as you can see, the components are less successful than the Departments. On average the corporations, like the Federal Home Loan Bank System, a very large Government corporation, had been doing it longer and are more successful. So, here again, we see that if you've been at it a while, you tend to be good at it.

We've been, in our Federal Financial Management Status Report and 5-year plan for 1995, 1996 and, finally for 1997, been tracking this in detail. The CFOs look at these, and keep score on themselves. And you'll see that timeliness is again shown here. And we want to continue to do that.

In it's report, GAO states, and we concur, considerable effort is already underway to make such improvements to show that progress. Several agencies which have been audited for a number of years face serious deficiencies in their initial audits, and have made good progress in resolving them—and this is a GAO quote—"with concerted effort." And that's what we're really here to talk about today. The Federal Government as a whole can continue to make progress toward generating reliable information on a regular basis.

Mr. Sessions, I agree with you. There is no other standard but reliable information on a regular basis that's acceptable.

There's been good progress over the last several years. Specific success stories include Government savings identified as a result of agency audits, as well as clean opinions for the Internal Revenue Service, GSA, Social Security Administration, Bureau of Public Debt, and Department of Energy.

The administration specifically rejected granting waivers. The statute, GMRA, allowed us—allowed me, actually—to grant waivers for this purpose. We said, no waivers. GAO has indicated that the "no waivers" policy, subjecting everybody regardless, was a key ingredient in getting as good information as they have. It's not good information, but as good as it was.

Characterizing the joint efforts of OMB, GAO, the agencies and Treasury, Barry Melancon, president and CEO of the AICPA says, "Taxpayers deserve no less than a full accounting. As a catalyst for change, audited financial statements provide a framework in which to evaluate the Government's financial management tax dollars and to initiate any corrective actions." I think that was well put.

The administration had identified a series of actions needed to correct the weaknesses in the consolidated audit and these plans are in the midst of implementation. For example, at DOD, completing a new accounting systems architecture, reviewing inventory, accounting processes, and developing a Governmentwide property accountability system is key to the Governmentwide statement. As well, Treasury has set up efforts with agencies to ensure effective cash disbursement reconciliation and for providing frequent analysis of cash receipts and disbursements.

Treasury and OMB are coordinating efforts to resolve problems agencies have in eliminating transactions among themselves. We'll include with that the use that has already been piloted of bank cards, where money doesn't leave the Government, but it provides a good reconciliation. Just as your bank statement includes all of the checks you wrote, we can use this network that banks create, a private sector network, to reconcile our intragovernmental payments without the money ever leaving the Treasury. It would be silly to send it out to the banking system and take it back among our own payments.

In conclusion, Treasury, the agencies, and GAO have completed a massive task on time. Again, Mr. Chairman, that timeliness is very important. On time.

The first ever audit was the largest ever undertaken in history. Some have suggested Hammurabi may have had a larger one at some point; we're researching that. It required massive transmissions of data and reconciliations that have never been attempted before. Getting the agency data to Treasury, preparation of financial statements, and completion of GAO's review, required close coordination over several years. Gerry Murphy, Gene Dodaro, and I have gone out now for 3 years in a row to the agencies, as a group, getting them ready; getting them ready over that 3-year period.

GAO's Acting Controller General, Jim Hinchman, had said completion of this effort on time was a credit to all who participated, and I agree.

As we complete the fiscal year 1997 audit process, plans are already in place and are being developed for the fiscal year 1998 process. Agencies will have a higher standard—a higher standard, new accounting standards are kicking in in fiscal year 1998. Some of them may go down in your grading system, Mr. Chairman.

New accounting standards on revenue and cost accounting are effective for fiscal year 1998. These new standards will prove difficult for many agencies, but they're essential to GPRA. If we can't get good cost accounting information, we can't do the kind of work that is necessary in GPRA.

We expect to see improvements next year and are working hard to make that expectation a reality. Again, in the 5-year plan we show, year by year, how many clean opinions we expect. We set a high bar, and some folks may not make that bar. We also show the timeliness of those opinions. We'll stand by this document which we revise each year, and it'll give you a plan scorecard, and you can do the actuals. We'll do the plan and you can do the actuals, over time.

That concludes my remarks, and at the appropriate time, I'll be happy to take any questions.

[The prepared statement of Mr. DeSeve follows:]

INTRODUCTION

Thank you Chairman Horn and members of the Subcommittee. I am here today to discuss the results of the first-ever audit of the Federal Government's Consolidated Financial Statement. We welcome the Congress' interest in this process and look for your support as we continue to work together to correct the decades old weaknesses identified by the General Accounting Office in its audit.

The Clinton Administration has aggressively advocated accountability, including financial statement audits, since the beginning of this Administration. In September 1993, the National Performance Review (NPR) recommended that the Federal Government prepare an annual consolidated financial report. In addition, the NPR supported the creation of a comprehensive set of basic accounting standards for the Federal Government. In the latter instance, NPR was critical of the amount of time it was taking to put accounting standards in place. The Administration, in agreeing with the NPR recommendations, committed to having a basic set of accounting standards in place and we have met that commitment.

In 1994, the Administration strongly supported, and the President eagerly signed, the Government Management Reform Act (GMRA) to require all major agencies and the government as a whole to prepare and have audited financial statements. We did this to create a clear basis for addressing accumulated problems in financial and asset management.

We knew from the beginning that this massive undertaking could not be completed in its first year nor in its second year. For several agencies, it would take many years to obtain an unqualified opinion on their financial statements. But we expected to see improvements each year in the accuracy, reliability, and timeliness of agency financial statements. We have seen that progress.

STANDARDS, POLICIES AND PROCEDURES

The first step towards implementing GMRA requirements for agency audits for FY 1996 and a government-wide audit for FY 1997 was to put in place policies and procedures, and to issue accounting standards for the Federal Government. As a founding member of the Federal Accounting Standards Advisory Board (FASAB), OMB worked with Treasury, other Executive Branch agencies, GAO, CBO, and private sector representatives to produce from scratch a complete set of accounting standards. According to the current, well-recognized chair of the FASAB, these standards were produced quickly compared to other standard setting bodies and encompass a broader range of issues than these bodies are used to dealing with. OMB also issued guidance on the Form and Content of Financial Statements and issued the Audit Bulletin to provide guidance to agency auditors.

Recognizing that we did not expect to receive an unqualified opinion on the first consolidated Federal financial statement, the President's FY 1999 budget includes a target for having a clean audit opinion on the government-wide statement for FY 1999. In addition 23 of 24 major agencies target timely and clean opinions for FY 2000.

CONTINUOUS PROGRESS

In its audit report, GAO states and we concur that:

> "Considerable effort is already underway to make such improvements. Several agencies which have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them. With concerted effort, the Federal Government, as a whole, can continue to make progress toward generating reliable information on a regular basis."

There has been good progress over the past several years. Specific success stories include government savings identified as a result of agency audits, as well as clean opinions for the Internal Revenue Service (IRS), the Social Security Administration (SSA), the Bureau of Public Debt, and the Department of Energy.

- The audit process has allowed the Government, for the first time ever, to estimate the percentage of improper payments in the Medicare program -- estimated at $23 billion in FY 1996. This Administration is proposing to take a number of steps to combat fraud and abuse which will result in future savings.

- For fiscal year 1997, the Internal Revenue Service will receive a clean opinion on its financial statement from the GAO. This means that $1,622 billion of revenue, 95 percent of the revenue that funds the Federal Government, passed the audit tests.

- The Social Security Administration -- the Federal Government's largest domestic program -- has had a clean opinion since 1994.

- The Bureau of Public Debt, which oversees $3.8 trillion of Federal obligations held by the public and interest payments related to those obligations in excess of $246 billion, also received a clean opinion on its 1997 statements.

- The Energy Department received a clean opinion on its financial statements including its disclosure of environmental liabilities totaling $181 billion.

- Eight of the 24 major agencies received clean opinions on their 1997 financial statements. Two more agencies anticipate that they will receive clean opinions. In other agencies, the financial statements of large components received clean opinions, such as the Internal Revenue Service, Bureau of Public Debt, Bureau of Alcohol Tobacco and Firearms, and Custom Service within the Treasury Department.

The Administration specifically rejected granting waivers, choosing instead to complete this audit process allowing for full disclosure of this information and a thorough and complete review by GAO. GAO has indicated this decision was critical to their completing their work on time.

Characterizing the joint efforts of OMB, GAO, and Treasury, Barry Melancon, President and CEO of the AICPA said, "Taxpayers deserve no less than a full accounting of where and how their tax dollars are being spent. As a catalyst for change, audited financial statements provide a framework in which to evaluate the government's financial management of tax dollars and to initiate any needed corrective actions."

NEEDED ACTIONS UNDERWAY

The Administration has identified the actions needed to correct the weaknesses identified in the consolidated audit and these plans are in the midst of implementation. For example, plans at the Department of Defense include completing a new accounting systems architecture, reviewing inventory accounting processes and developing a department-wide property accountability system. OMB, Treasury and GAO are working with the major credit agencies to improve the reporting of loans and loan guarantees.

As well, Treasury plans to step up its efforts with agencies to ensure effective cash disbursement reconciliations by providing frequent analysis of cash receipt and disbursement differences so that they can be promptly resolved.

Treasury and OMB are coordinating efforts to resolve the problems agencies are having in eliminating transactions between agencies. Treasury and OMB will strengthen the requirements for agencies to capture information needed to reconcile balances with their Federal trading partners. Treasury will also begin modifying its systems to support agency efforts.

In an effort to determine the full extent of improper payments that occur in major Federal programs, OMB is working with GAO, the agency Inspectors General and agency staff in identifying at risk programs and designing a cost effective approach to assessing the extent of improper payments and appropriate remediation measures. Audits of Federal programs pursuant to the Single Audit Act Amendments of 1996 and implementing OMB guidance will be the principal mechanism for assessing the extent of improper payments.

Finally, Treasury will increase its formal and informal training of agency financial management personnel. The training will address common errors identified in agency information used in the preparation of the U.S. Government's FY 1997 consolidated financial statements.

CONCLUSION

Treasury, the agencies and GAO completed the massive task on time. The first ever audit was the largest ever undertaken in history. It required massive transmissions of data, reconciliations that had never been attempted before, application of new systems and new accounting principles. Getting the agency data to Treasury, preparation of the financial statements, and completion of GAO's reviews required close coordination that had never before been attempted.

GAO Acting Comptroller General James Hinchman said completion of this effort on time was "a credit to all who participated."

As we complete the FY 1997 audit process, plans are already in place or being developed for the FY 1998 audit process. Agencies will have a higher standard to meet in FY 1998 -- new accounting standards on revenue and cost accounting are effective for FY 1998. These new standards will prove difficult for many agencies. As well, agencies are addressing weaknesses identified in the FY 1997 audit process. We expect to see improvements next year and are working hard to make that expectation a reality.

I would be happy to answer any questions.

Mr. HORN. Well, we thank you very much for that statement. And before I have Mr. Murphy start his particular statement for the committee, I want to note something about Mr. Murphy. He's a good example of career civil servant in two fine departments. He started when I was in graduate school with the Navy in 1957, and then moved over to Treasury in 1959. Now, in the 1950's, I want you to know, that the Navy had the finest personnel program in this city, as I recall, and Treasury has historically had a very fine program for civil servants, and Mr. Murphy has hit all of those various points.

He was Assistant Secretary for Fiscal Affairs, and held numerous positions besides the one I mentioned in introducing him, as the senior advisory to Under Secretary for Domestic Finance, and the senior to whom he reports is right to his right and my left. But what I'm introducing you for, Mr. Murphy, is because you are a Certified Public Accountant, you're a former president of the Association of Government Accountants.

Before you even start on that statement, I want you tell me in simple English, what is net cost, as seen in this particular consolidated statement. I think that's something that a lot of people will not understand. So you can just speak from your heart on the great idea of net cost. You get to it on page 3 of your statement, but there isn't a full explanation. And then we'll let you go ahead.

Mr. MURPHY. You want me to answer that question first?

Mr. HORN. I want that question first and then I'll be glad to hear the statement.

Mr. MURPHY. The focus of the financial statements, as prescribed and encouraged by the Federal Accounting Standards Advisory Board, is to focus on net costs, meaning the costs of Government operations on an accrual basis less the related exchange-type revenues, those revenues that we generate as a result of some of our operations. So we come up to a net cost figure there.

That doesn't include, then, the gross revenues, the non-exchange revenues, the various taxes that the Government collects to finance that net cost.

Mr. HORN. OK. [Laughter.]

Now, the accrual aspect goes back to a recommendation of the Hoover Commission in 1949 and 1952, but we don't really apply it too often, but I take it we are applying it now.

Mr. MURPHY. We are now. It's been a long struggle.

Mr. HORN. Right. Just a half century.

Mr. MURPHY. At one point in time, accrual accounting seemed to be too complex for laymen to grasp and there wasn't a great deal of interest in it. Everyone has embraced that because it's necessary to have good cost data, which, in time, we'll be able to compare to performance measures prescribed under the Government Performance and Results Act.

Mr. HORN. Very good. Well, proceed with your statement, now.

Mr. MURPHY. Thank you, Mr. Chairman, and thank you for the introduction. I wasn't expecting that.

Mr. DeSeve has covered a number of things in my testimony, and rather than be redundant, I'd like to submit my full statement for the record, and I'll summarize it for you.

Mr. HORN. Without objection, it's inserted, as are all statements, the minute we introduce you. They're already shipping it down to GPO. [Laughter.]

Mr. MURPHY. The Department of Treasury has been and continues to be a strong proponent for the development of financial statements by Government agencies. This is the very first audit, as has been pointed out, and it is the capstone of a process that began 8 years ago.

In 1990, the Office of Management and Budget, the Treasury, and the General Accounting Office created a new Federal Accounting Standards Advisory Board to come up with a comprehensive set of generally accepted accounting standards that we could all follow, and that process is still underway. The basic core requirements came out in fiscal year 1996. They were brand-new standards. Some were applicable for the first time in 1997, and there are four more new standards effective in 1998.

So as agencies are attempting to improve their financial systems, we're also raising the bar on them, so to speak, because new standards coming out each year provide new challenges for agencies to comply with. We now have, as Mr. DeSeve pointed out, the 24 largest executive departments and agencies being audited. We have the government corporations also being audited.

The consolidated financial statement is based on those agency statements and the agency audits. Under the Government Management and Reform Act, as you mentioned, Mr. Chairman, the statutory due date for Treasury and GAO to produce this audited, consolidated statement, was March 31. We also took note of the fact that the statute requires the agency audited statements by March 1. And we knew that the General Accounting Office, in order to render its audit opinion by March 31st, would need consolidated numbers from the Treasury by the middle of March. We also knew that from prior year experience, some agencies were going to have difficulty meeting that March 1 date.

So, in order to compile the entire Governmentwide statement, we had to do a number of things. One of the things we did was to ask agencies to submit pre-audited data to us by February 15, 2 weeks before the statutory date. We knew that that data would be largely unaudited, but we said, give us something on February 15 so we can get started, and you can submit adjustments to us after the fact. We did that, but even when we closed off the consolidated statement, there were still some agency audits that had not been completed.

In order to meet the statutory date, several things were absolutely crucial. One, we needed the agencies to submit data from all their separate accounting systems to the Treasury using the standard general ledger codes that Treasury maintains. We also needed them to telecommunicate the data to us over our electronic facts system. And, third, we needed some very dedicated and conscientious people in the Treasury Department to pull all these numbers together, prepare all the narrative for the statements, and get everything to GAO on time.

Gene Dodaro recognized some of his people, Mr. Chairman, if you don't object, I'd just like to mention a few from Treasury.

Mr. HORN. Why don't they stand up as you call out their name.

Mr. MURPHY. OK. I doubt that they're all here. We did have as many, perhaps, preparing the statement as were engaged in auditing it. We have a small group of about 13 people that is managed by Faye McCrery, who did yeoman work here. We have a couple professional accountants, Gary Ward and Jose Placer, who did a lot of the technical work. And we have several supervisors, managers, including Bill Patriarca, Jim Chambers and Holden Hogue, who oversaw the preparation. We also had Ron Longo from the department who helped us in a great way. So, to the extent that these folks are here, I wish that they——

Mr. HORN. Why don't we have them stand up? Well, a few under 13. [Laughter.]

Mr. MURPHY. The rest are working, Mr. Chairman.

Mr. HORN. They're at work. OK. We thank you; tell the rest thank you. It's a tough job pulling these documents together and moving all those data around.

Mr. MURPHY. It was a huge undertaking and we were very pleased to be able to submit the report on a timely basis and pledge to do so in the future as well.

The publication of this statement is another stage in the administration's continuing efforts to improve management and efficiency in Government. As has been mentioned, we were strong supporters of the Government Management and Reform Act. The audit results provide the roadmap for our improvement efforts and a number of those are underway.

A note on some of the things that are in the financial statements and some of the things that are not. By and large, the accounting standards require that those Federal entities that are in the President's budget be included in our consolidated financial statements, and, generally speaking, those entities which are not in the President's budget are not in our consolidated financial statements.

For example, the Government-sponsored enterprises are not in our financial statements because they're privately owned. The Federal Reserve Bank operations are not in the budget, since monetary policy aspects are usually operated from the rest of Government. Therefore, they are not included in our financial statement. We do have a footnote explaining the role of the Federal Reserve and our relationship with it.

Anything that's privately owned is excluded. Some of the post exchange military operations are privately owned. We would exclude things like Amtrak; even though it gets some money from the Federal Government, it is privately owned.

The other caveat that I would like to just mention briefly in terms of reading the financial statement, is that you have to appreciate the fact that there are a lot of assets that aren't on that balance sheet. The Government produces a lot of assets that we don't own ourselves. We invest in highways and airports, in water projects, school buildings. These are assets on somebody else's balance sheet. We show the cost of those, but they don't show up as assets on our balance sheet.

Then there are some assets that we own, but they don't show up on the balance sheet under current accounting standards, right now. The public domain land, for example. Almost 80 percent of the acreage in the United States, there's no value placed on that public domain land on our balance sheet. We have natural resources, including oil and gas, and timber, that are assets that the Government owns but they're not being valued on the balance sheet. We include some information in the statements on those items.

In future reports under accounting standards that take effect in subsequent years, we'll be providing more information on many of those kinds of items.

In conclusion, I'd just like to say that since 1990, there has been a lot accomplished, and I appreciate the chairman's and Mr. Armey's recognition of some of those accomplishments. Obviously, we have a long way to go, a lot of things that need to be worked on.

Treasury is committed to working with the Office of Management and Budget, the General Accounting Office, and the agencies. We have efforts underway to deal with some of those areas that were cited as problems: the reconciliation of the agency check books with Treasury's accounts, the elimination of intragovernmental transactions which have created difficulties in reconciling among Federal trading partners. All of these items are being addressed, and we look forward to improving the quality of data in future years.

With that, Mr. Chairman, I'll conclude my remarks, and I'd be happy to answer any questions.

[The prepared statement of Mr. Murphy follows:]

EMBARGOED UNTIL 9:30 A.M. EST
Text as Prepared for Delivery
April 1, 1998

TREASURY SENIOR ADVISOR TO THE UNDER SECRETARY
FOR DOMESTIC FINANCE GERALD MURPHY
HOUSE GOVERNMENT REFORM AND OVERSIGHT SUBCOMMITTEE ON
GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY

Mr. Chairman and members of the Subcommittee, I am pleased to appear today to discuss matters involving the first Consolidated Financial Statements of the U.S. Government (CFS).

BACKGROUND

The Department of the Treasury has been and continues to be a strong proponent for the development of financial statements for Government agencies. This is the first time audited consolidated financial statements are required to be prepared on a government-wide basis. The statements are intended to provide the President, the Congress, and the American people with information about the Government's financial position, the cost of its operations and its sources of financing. They are the capstone of a process which began eight years ago as a result of legislation originating with this Committee.

In 1990, Congress passed the Chief Financial Officers (CFO) Act which required the preparation and audit of financial statements for certain agencies and components of agencies. That same year, the Office of Management and Budget (OMB), Treasury and the General Accounting Office (GAO) created the Federal Accounting Standards Advisory Board (FASAB). This body has created a comprehensive set of accounting standards tailored to the unique characteristics and needs of the Federal Government. The Government Management Reform Act was passed requiring that the Federal Government's 24 largest departments and agencies produce audited financial statements beginning in FY 1996. Agency statements are due March 1. The first

Consolidated Financial Statements for FY 1997 are based on the financial statements prepared by Federal agencies under those statutes and the new accounting standards.

THE ROLE OF THE DEPARTMENT OF THE TREASURY

The Government Management Reform Act of 1994 (GMRA) requires that not later than March 31 of 1998 and each year thereafter, the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, shall annually prepare and submit to the President and the Congress an audited financial statement for the preceding fiscal year, covering all accounts and associated activities of the executive branch of the United States Government. The financial statement shall reflect the overall financial position, including assets and liabilities, and results of operations, of the executive branch of the United States Government, and shall be prepared in accordance with the form and content requirements set forth by the Director of the Office of Management and Budget. The Government Management Reform Act also requires the Comptroller General of the United States to audit the CFS.

THE PREPARATION OF THE CFS

In order to prepare the CFS by the statutory due date, it was necessary to request agency trial-balance data by February 15. Much of this information had not yet been audited but was transmitted to the Financial Management Service (FMS) electronically so we could get started. Subsequent audit adjustments were accepted, but not all agencies had completed audits when we closed our books to meet the statutory due date.

The data transmitted needed to be standardized throughout the Federal Government to allow for summarization at the government-wide level. This standardization was accomplished by requiring agencies to use the U.S. Government Standard General Ledger (SGL). The SGL is maintained by FMS and is required for agency level accounting and reporting as well as government-wide reporting. Without the SGL, data could not be summarized for the CFS. Approximately 2000 individual reporting components, each with many account balances, were telecommunicated to Treasury via our FACTS system. Without the electronic transmission system, data could not have been collected and processed quickly enough to meet the statutory due date.

The size and complexity of the CFS preparation process far exceeded any previous financial consolidation effort. The data came from the 24 CFO Act agencies and many more smaller ones. Each agency acts as an independent financial entity and maintains its own financial system. To consolidate data from all these various systems was a daunting task.

However, it is not enough to collect the data and be able to summarize it. There has to be a reporting model. The Government Management Reform Act specified that OMB set forth the form and content requirements for the CFS. The CFS prepared by the Department of the Treasury conforms to OMB's form and content requirements. The reporting model used was recommended by FASAB and prescribed by OMB.

DISCUSSION OF THE CFS

General

The U.S. Government has continuing responsibilities for the general welfare of its citizens and for the national defense. It also has unique access to financial resources in that it has the power to tax, to borrow and to create money. The Fiscal Year 1997 Consolidated Financial Statements of the United States Government represent the Federal Government's first effort to prepare, in accordance with new Federal accounting standards, financial statements that include all of its vast and complex activities and to subject the financial statements to the rigors of an independent audit.

The publication of the audited financial statements represents yet another stage in the Clinton Administration's continuing efforts to improve the management and efficiency of the United States Government. In 1994, the Administration strongly supported the Government Management Reform Act, which mandated the issuance of the audited financial statements. Despite the substantial progress that has been made, however, further improvements are clearly necessary. The audit report from GAO discusses many areas in which the reliability of the current financial statements must be enhanced and improved. As a result, GAO was unable to render an opinion on these statements.

The FY 1997 Consolidated Financial Statements are the first step in an effort to provide the President, the Congress and the American people with reliable information about the financial position of the United States Government on an accrual basis, the net cost of its operations, and the financing sources used to fund these operations. The United States Government does not have a single bottom line that reflects its financial status but the information included in the statements provides a view of the Government's finances that has not previously been available. The financial statements consist of Management's Discussion and Analysis (MD&A), a Balance Sheet, a Statement of Net Cost, a Statement of Changes in Net Position, Notes to the Financial Statements, and Supplementary Information, which includes a stewardship section.

Reporting Entity and Basis of Accounting

The financial statements include the executive branch and limited information from the legislative and judicial branches of the Federal Government. Information from the legislative and judicial branches is limited because they are not required to prepare financial statements covering all activities. For example, the property, plant, and equipment of the judicial branch and the Congress are not reflected in the statements. Excluded because they are privately owned are Government-sponsored enterprises such as the Federal Home Loan Banks and the Federal National Mortgage Association. The Federal Reserve System also is excluded because organizations and functions pertaining to monetary policy are separate from and independent of the other central government functions.

At the time Congress passed the CFO Act which required the preparation and audit of financial statements for selected components, the Federal Government did not have a comprehensive set of generally accepted accounting standards. The three principals concerned with overall financial management in the Federal Government (the Secretary of the Treasury, the Director of OMB, and the Comptroller General) created the Federal Accounting Standards Advisory Board (FASAB) to address this need. The accounting standards developed by FASAB are tailored to the Federal Government's unique characteristics and special needs. Consequently net costs, rather than profit, are used as the primary financial measure for assessing efficiency and effectiveness. Although FASAB completed work on the basic set of Federal Financial Accounting Standards (FFAS) in 1996, some of the standards did not become effective until Fiscal Year 1997 and others will become effective in Fiscal Years 1998 and 1999. Therefore, agencies are faced with improving systems while the requirements are changing.

CONCLUSION

Since passage of the CFO Act in 1990, much has been accomplished. There is now a comprehensive set of accounting standards in place. For the first time in its history, the Federal Government has prepared and subjected to audit consolidated financial statements covering all its vast and complex programs and activities. The 24 agencies subject to the CFO Act are issuing audited agency wide financial statements. Government corporations subject to the Government Corporation and Control Act also are issuing audited financial statements. While these accomplishments are significant, they are just a beginning.

The Administration has designated financial management as one of the President's priority management objectives. The Administration has expressed its commitment to assuring the integrity of Federal financial information and gaining an unqualified opinion on the 1999 Consolidated Financial Statements of the United States Government. For the Administration to achieve these objectives, agencies must improve the quality of their financial information. Agency commitment to the Administration's objectives is reflected in OMB's Federal Financial Management Status Report and Five-Year Plan. That document sets forth the dates by which agencies have pledged to submit timely financial statements with unqualified audit opinions.

Weaknesses in agency accounting practices and financial management systems are the fundamental cause of problems that precluded the auditor from rendering an opinion on the FY 1997 Consolidated Financial Statements. Actions to correct these weaknesses have been identified and are being implemented. OMB, Treasury, and GAO are working with the major credit agencies to improve reporting of loans and loan guarantees.

In addition, Treasury plans to step up its efforts with agencies to ensure effective cash disbursement reconciliations by providing frequent analysis of budget clearing accounts so that cash receipt and disbursement differences can be promptly resolved.

Treasury and OMB are coordinating efforts to resolve the problems agencies are having in eliminating transactions with other Federal agencies. Guidance and requirements will be provided to enable agencies to capture information needed to reconcile balances with their Federal trading partners. Treasury will also begin the modification of its systems to support agency efforts.

Finally, Treasury will increase its formal and informal training of agency financial management personnel. The training will address common errors identified in agency information used in the preparation of the Federal Government's 1997 Consolidated Financial Statements.

Thank you, Mr. Chairman. This concludes my formal remarks. I will be happy to respond to any questions.

Mr. HORN. If Mr. Dodaro will now join us again, we'll have a panel here, and a dialog between the executive branch and the representative of the legislative branch.

Let me just ask first, on the opinion of GAO, what effect, if any, does the lack of effective systems of internal control have on the information provided in the financial statements, and what about ad hoc reports and inquiries made by management at various agencies, OMB, and also Congress? Do you have any feeling on that?

Mr. DODARO. Weaknesses in internal controls is a very important issue. And basically our findings were, in many of the agencies, that you cannot rely on the internal controls, particularly the computer controls, in order to do the audits. So there's a lot of testing that has to be done and ad hoc procedures to be developed. Our view is that those internal control weaknesses really need to be fixed along with getting more accurate information if you're really going to have the systems in place to generate information on a reliable, timely basis.

Right now, that doesn't exist in most parts of the Federal Government. There's a lot of ad hoc data gathering that occurs. And when it's subjected to the rigors of an audit, and somebody has to go behind the information as the auditors do, and ask how did you generate that estimate, or how did you come up with that figure, then basically, the data's not there. So fixing the internal control problems across the Government is an integral part of being able to produce reliable, timely information.

Mr. HORN. Your statement, in your formal testimony, discussed widespread computer control weaknesses. You were concerned, correctly, about security. You mentioned, as did the administration, the year–2000 problem, and I just wonder what effect, if any, do these weaknesses have in the Government's efforts to gain control of its resources, in terms of basic computer weaknesses? Or have we never put the information into the data base to start with?

Mr. DODARO. I'm not sure I understand the question.

Mr. HORN. Well, I'm thinking about one, we do have a problem with internal controls between computers. Some don't talk to each other, even within the same executive department. Then the question comes in talking with each other within the executive branch. Then comes the question can GAO audit that and find it, and what do we need to do about solving some of that?

Mr. DODARO. Basically, one of the core tenets of OMB's plan, the CFO council plan, is to develop integrated financial management systems. That really lies at the heart of a lot of the problems at the Defense Department, for example. Systems aren't integrated so DOD does not have the normal checks and balances in place. So, basically, the computer weaknesses occur in part because a lot of the systems were generated as stand-alone systems. In fact, most of the information to prepare the financial statements, say, for example, at Defense, comes from logistical systems; about 80 percent of the information. And, also, there are weaknesses in the general ledger control systems of agencies, so that check that you'd have in place between the general ledger system and checks and balance with the logistical systems are not there.

The one thing I didn't mention in my opening statement that's in our report was the legislation that Congress passed in 1996 called the Federal Financial Management Improvement Act. What that act requires——

Mr. HORN. That was Senator Brown's legislation, wasn't it?

Mr. DODARO. Yes, exactly. And what that legislation requires is beginning in fiscal year 1997, auditors doing audits under the CFO Act are to determine whether agencies not only meet accounting standards, but meet systems requirements that are published by the Joint Financial Management Improvement program and codified in executive branch OMB-bulletins, as well as the standard general ledger.

So far this fiscal year, only 4 agencies have really passed that test, which shows you some indication of the underlying systems weaknesses and the computer controls that need to be fixed in order to meet the objective that you're talking about.

That piece of legislation is a very good complement to the audit requirement because it is basically driving the agencies not only to have end-of-year data that's accurate, but making the systems changes to be able to have data year-round that can have some integrity to it.

Mr. HORN. Well, as I remember, the last time I looked into the Defense Department, when I was searching for that $25 billion they couldn't account for, there were 49 different accounting systems in the Department of Defense. Is that still true?

Mr. DODARO. Actually, Mr. Chairman, there were, at last count, 249——

Mr. HORN. 249?

Mr. DODARO. 249. They forgot the——

Mr. HORN. They dropped the zeros when they sent it over here. I thought it was enough to have 49, at the time. So now it's 249?

Mr. DODARO. Yes, they have been in the process of trying to consolidate and migrate their systems, but as Mr. DeSeve mentioned in his opening remarks, they don't have an overall systems architecture.

As you know, one of the key requirements in the Clinger-Cohen act that set up the Chief Information Officers was that agencies were required to have an architecture. And unless you have an architecture that shows the data flows and that have technical standards that the systems can interrelate with one another, to be interoperable, agencies are not going to be able to design systems that can talk to one another. Those architectures are not in place now. It's a goal, as Mr. DeSeve knows as chairman of the CIO council, the CIOs have made that an important goal, to have architectures.

So this is a case where the CIOs really need to work with the CFOs to put in place data architectures and systems that can generate this type of information.

Mr. HORN. If I can get in one question to Mr. DeSeve before yielding. In your statement, you state that your goal is a clean and timely audit opinion on the consolidated statements by the year 2000. With half the agencies not able to issue audited financial statements in a timely way, and only 8 of the 24 having clean opinions in the second year the Government Management and Reform Act required such audits, 5 years after the act was passed, what makes you believe this goal is obtainable?

Mr. DESEVE. I think what you see before you today is a visual representation of the working together of Treasury, GAO, and OMB. What you don't see—and you're going to have another set of hearings—is the work that the agencies are doing.

My optimism, or my setting the bar high—and I'll admit here today that I'm setting the bar high—is based on work that GAO is currently doing, the people behind us, the work that OMB and Treasury are currently doing at the Defense Department. I met with the Controller of the Defense Department on Monday and we talked about the inventory control system and how the inventory control system was developing. GAO has done some marvelous work with DOD in using logistics systems, using inventory systems, getting the information, and using sampling techniques.

Last night I met with HCFA. HCFA a year ago had a disclaimer on its opinion from its Inspector General. This year the opinion will be qualified, it will not be a disclaimer. It's not clean yet, but the major items, as my good friend Woody Jackson—who's not here and deserves to be recognized as he set the framework for this, as Woody Jackson said, the thunder-boomer issues in HCFA that would impede our ability to get a clean statement Governmentwide have been dealt with.

The issue that we always work on in auditing—and I'll ask Mr. Dodaro or Mr. Murphy to comment on it—is materiality. The fact that, let's say, two or three agencies don't have a clean opinion of their own books, those qualifications may not be material to the larger entity. Mr. Armey, when he spoke earlier of his bass boat, his bass boat is probably immaterial to Mr. Armey's overall net worth, even though he can't find it. I don't know his net worth, so I wouldn't want to comment.

But what we're doing, what we're working on very hard, the reason we were worried about the IRS, the reason that we were worried about Social Security, the reason that we worried about GSA, the reason that we worried about Energy, the reason we were worried about the Bureau of Public Debt, those entities, all of which are now clean, is that they would have a material impact on the Government as a whole. If we couldn't calculate our environmental liabilities from the Nuclear Regulatory Commission, or we couldn't calculate the revenues coming in from the IRS, if we couldn't calculate the Social Security payments and be able to explain how they work, those would be material.

DOD property, plant, equipment, and inventory, is material. DOD environmental liability is material. HCFA payment systems and reconciliation of their accounts receivable are material. So we're working together, the three of us are working together on the big, material items, at the same time the agencies are working on either their components or their department-wide entities.

And I would ask Mr. Murphy or Mr. Dodaro that we've worked very closely with to comment.

Mr. DODARO. Yes, I reinforce what Mr. DeSeve is talking about, but Mr. DeSeve also knows that I mentioned that achieving that clean opinion in 1999 is a stretch goal——

Mr. DESEVE. Yes, it's a stretch goal.

Mr. DODARO. And I also think that the Defense Department is the critical path to that goal. As Mr. DeSeve mentioned, by any standards, DOD is material to the assets, liabilities, and also net costs—as you mentioned, the disbursement problem over at DOD.

And there are other key parts of the Federal Government that need to work on that, and our recommendations address that. Also the Governmentwide accounting issues that I articulated need to work. And I'd also reinforce the point that was made earlier by both Mr. Murphy and Mr. DeSeve, is that there are new standards coming into place in the next couple of years that are going to require agencies to develop full costs aligned with program activities, to come up with the deferred maintenance costs. This is a very important component. I know the Appropriations Committees are looking forward to having some reliable data on, are the deferred costs of operating the Federal Government.

There is also a revenue standard coming in place that would require IRS to report by type of tax, something that they're not currently able to do. So we're trying to work with them to figure out the best way to do that.

So, major parts of the Government still need a lot of attention, and new standards are coming in to place. The key goal is just out-and-out hard work and determination to really address these problems head-on, and I believe progress is possible, but it will take a much more elevated effort to achieve that goal.

Mr. HORN. I thank the gentleman. Since I went well over my 5 minutes, I yield to the gentleman from Ohio, the ranking minority member, Mr. Kucinich, 10 minutes for questioning the witnesses.

Mr. KUCINICH. First of all, I want to thank the Chair for his indulgence and begin by saying that this first ever audit of the Federal Government's books submitted today represents a monumental effort by the administration and by the GAO. And it's the largest such audit in history. The American people need to understand this, that it's required enormous data transmissions, unprecedented reconciliations, and development and application of new accounting principles and systems. And I would like to commend everyone, and every one of the witnesses, for accomplishing this task on time. It was a huge effort, and it could not have been possible without the dedicated work of thousands of men and women at the General Accounting Office, the Department of Treasury, and the Office of Management and Budget. So at this moment, they ought to be congratulated and I thank them.

The administration, it should be pointed out, has not only balanced the budget, it's dedicated to bringing more financial accountability to Government, and this audit is a milestone in that effort. American taxpayers expect, and they deserve, a full accounting of when and where and how their tax dollars are spent. I know the chairman of this committee has been very dedicated to that, and I salute him for that. And the President, and the National Performance Review under Vice President Gore, has embraced this principle early in their first term.

I think we all remember that in December 1993, the NPR recommended the preparation of annual consolidated financial report, and the creation of comprehensive Governmentwide accounting standards. This proposal became part of law in the Government Management and Reform Act of 1994 that was passed by our Congress and eagerly signed by the President.

The American people are going to be pleased to know that many of our Government's most important agencies have received clean audit opinions. Everyone sure wants to know that the IRS has a clean audit opinion. And with the issues surrounding Social Security, we all want to know that the Social Security Administration has a clean audit opinion—that should give people faith in that system. And, of course, the Bureau of Public Debt.

Now, other agencies are making good progress and moving toward clean opinions. From what I've seen presented, and information that our committee has received, the administration is committed to resolving the decades-old problems in financial and asset management. Of 24 agencies, 23 have promised to have timely and clean opinions for fiscal year 2000. We have seen steady progress from the agencies on this front, and should expect it to continue.

Now, to be sure, we have problems that remain. And I know this committee under the chairman is sure going to get to those problems. For example, he looked at the Department of Defense. This committee has been very active in its oversight of financial management problems at DOD, and I commend the Chair for his active pursuit of the issue.

DOD has some serious problems; accounting for assets, inventory and equipment, and it's also severely underestimated the amount of liability based on environmental costs—something that I'm personally very concerned about. This administration at least has brought us to the point where almost 100 percent of the Federal Government is at least audited, compared with only 30 percent in 1990. A hundred percent today, close to 100 percent, and 30 percent in 1990. That's a huge accomplishment.

And in addition, the number of major agencies receiving clean audit opinions has climbed steadily from only 2 in 1990 to what is expected to be 10 this year. That's real progress on a difficult problem, and I think as we begin looking into the implications of the audit, we can at least celebrate the moment, saying that we've come a long way. There is certainly a long way to go.

In the President's—I'd like to ask Mr. DeSeve—in the President's budget for fiscal year 1999 the administration identified 22 key management objectives. Third on that list—which I'm sure that you're familiar with, you helped put it together—is financial management, present performance and cost information in a timely and informative and accurate way, consistent with Federal accounting standards to ensure the integrity of Federal financial information by completing audits and gaining unqualified opinions for all Chief Financial Officer Act agencies and on the Federal Government as a whole.

What I'd like you to do, Mr. DeSeve, could you place the objective of improving the Federal financial management in some historical perspective, so you can help us even more clearly understand the significance of this moment?

Mr. DESEVE. I'd be happy to. The chairman talked about the Hoover Commission in the 1950's calling for accounting standards, calling for an accrual basis of accounting, and it's really taken us an enormously long time, almost 50 years, to realize the benefits. The CFOs Act in 1990 for the first time created organizations of men and women who were exclusively dedicated to financial management. We've had good success in populating those organizations, not only with the CFOs but also with the Deputy CFOs. Deputy CFOs tend to be permanent career civil servants who are the permanent CFO community as the political CFOs come and go, bringing valuable talent.

I was one myself, so I can hardly decry the political nature of the CFOs. They've had good access to their secretaries and good access to their administrators. So that was terribly important. It required a small group of agencies to have comprehensive audits.

I think the value of the audit at HUD—I haven't looked at the numbers yet—but when I got to HUD there was a disclaimer of opinion, there were about—I'm not taking credit for this, at all, please—there were about 40-some material weaknesses. This year, HUD will have one single qualification on its opinion. I haven't seen the number of material weaknesses. FHA and Ginnie Mae, the two major components of HUD will continue to have clean audit opinions, as they have in the past.

So it's that kind of progress of the CFO Act, but that wasn't enough. GMRA needed to extend to the rest of the 24 CFO Act agencies, and to the Government as a whole, that same high hurdle, that same stretch goal, of first getting an audit, second getting it clean and timely opinion. We were able to work with this committee under the leadership of its former Chairs to get that done. And this committee was absolutely instrumental in causing that to happen, and continues in its oversight in making sure—I've testified before on the CFOs Act implementation in this committee before this Chair.

Mr. KUCINICH. May I——

Mr. DESEVE. Sorry.

Mr. KUCINICH. May I ask you, though—I'd just like to keep this going—what particular challenges do you still have ahead in producing unqualified and timely audited financial statements for the 24 CFO agencies?

Mr. DESEVE. I think the challenge is going to be divided into probably three categories. The first category is being able to first reconcile the data in their existing systems, to be able to know the inventory data, to be able to know the loan-outstanding data, and to be able to properly tie that back to the historical patterns in those areas for loans. So it's first knowing the data, being comfortable with the data.

Second, being able to establish systems that will bring those data together, from the contractors, as well as internally. HCFA's biggest problem at the moment in getting a clean opinion, will be reconciling contractor-based data. We have to remember that there are—I think there are currently 9 or 10, I'll stand corrected on that—major contractors which process for HCFA. Their systems had never been designed to be integrated with HCFA's, so they need to know what data is there—the contractors have to know—HCFA has to be able to upstream that data.

And finally, then, to reconcile, to be able to reconcile with Treasury. To be able to reconcile internally for any of the inconsistencies as they exist. Those are the big challenges, getting control of data, getting control of systems, and a reconciliation process over time.

Mr. KUCINICH. Before we send this back to the Chair and to the other Members, there's one thing that I've been wondering as I go over this material, and that is, the Chair has been showing leadership on this issue of Y2K, the difficulty when we go to the year 2000 with the computers being set to revert back to the beginning of the century, my question to you is, what particular challenges do you face with respect to Y2K that would have an impact on your ability to audit, and have either some of these accounts we just talked about, or an audit process of the Government——

Mr. DESEVE. May I ask——

Mr. KUCINICH. When you cross that border, where are you with financial accounting?

Mr. DESEVE. Given the fact it was an audit, may I ask Mr. Dodaro, the auditor to answer that question?

Mr. KUCINICH. Mr. Dodaro, yes.

Mr. DODARO. Basically, a lot of the financial transactions are conducted through various integrated systems in place. For example, in the case of the Federal Government's bill paying activities, the agencies' financial systems have to integrate with Treasury's Financial Management Service to then make payments to financial institutions across the country. So, any inability of those data systems to basically deal with this problem and communicate accurately—in loan programs, for example, you have loan repayment schedules, you have dates when payments are due, the default dates could show up, even though the loan might be paid, installment agreements. You also have IRS revenue collection activities—there's a big challenge at IRS in making the changes in their system to deal with the year–2000 problem at the same time they're dealing with changes in the tax law. They have to do both, to be ready, at the same time. It's a huge challenge.

So, revenue collection activities to the Government could be affected. Many of the Federal Government programs rely on eligibility information, so it's obviously important to have accurate information on date calculations for the age of people as well. And without the change, the computer would read in 2000—somebody would turn 65 in 2000, if it's not corrected, would not recognize that they're eligible for Social Security or Medicare, for example. So it could have an enormous effect on the Federal Government's activities, if this problem isn't fixed. And that's why we're raising it as part of this audit opinion.

As you know, Congressman Kucinich, we were here 2 weeks ago talking about the broad implications of the problem on service delivery. In this context, we're raising it because it could have a very significant effect on the Federal Government's ability to report accurately in terms of its activities and carry out many of the financial aspects of its programs.

Mr. KUCINICH. Thank you. I want to thank the Chair for his kindness. Thank you.

Mr. HORN. Well, I thank the gentleman. That's a very important question, and if I might, just to help the point along, I will at this point put in page 23 of the General Accounting Office report where it gets into this in the document, and it carried over in the draft to the next page.

[The information referred to follows:]

B-279169

The majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and cannot provide reliable financial information for managing government operations and holding managers accountable. Auditors' reports for fiscal year 1997 agency financial audits are disclosing the continuing poor shape in which agencies find their financial systems. As of the date of this report, only four agency auditors have reported that their agency's financial systems comply with the act's requirements.

YEAR 2000 COMPUTING CRISIS

The Year 2000 computing crisis is the most sweeping and urgent information technology challenge facing public and private sector organizations.[6] The federal government is extremely vulnerable due to its widespread dependence on computer systems to process financial transactions and management information, deliver vital public services, and carry out its operations. This challenge is made more difficult by the age and poor documentation of the government's existing systems and its lackluster track record in modernizing systems to deliver expected improvements and meet promised deadlines.

Consequently, we surfaced the Year 2000 computing crisis as a high-risk area across government in February 1997. Unless this issue is successfully addressed, serious consequences could occur. For example,

—payments to veterans with service-connected disabilities could be severely delayed if the system that issues them either halts or produces checks so erroneous that it must be shut down and checks processed manually;

—the Social Security Administration process to provide benefits to disabled persons could be disrupted if interfaces with state systems fail;

—federal systems used to track student loans could produce erroneous information on loan status, such as indicating that a paid loan was in default;

—Internal Revenue Service (IRS) tax systems could be unable to process returns, thereby jeopardizing revenue collection and delaying refunds; and

—the military services could find it extremely difficult to efficiently and effectively equip and sustain its forces around the world.

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[6] For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data storage and reduce operating costs. In this format, however, 2000 is indistinguishable from 1900 because both are represented as "00." As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

B-279169

In the past year, we have issued over 20 reports outlining actions underway in a wide range of federal activities to address this challenge and providing numerous recommendations for additional improvements needed. Moreover, the President recently created a Council on Year 2000 Conversion, led by an Assistant to the President, to oversee federal agencies' Year 2000 efforts, speak for the United States in national and international forums, and coordinate with governments at all levels, as well as with the private sector. While some progress has occurred, a great deal of additional effort is required to prevent serious disruptions in government operations and in financial transactions and reporting.[7] We will continue to monitor this situation and make needed recommendations.

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

When the government is able to produce them, reliable consolidated financial statements will be a valuable tool for analyzing the government's financial condition. They will also help inform budget deliberations by providing additional information beyond that provided in the budget on the long-term cost implications for a wide range of government programs. The largely cash-based budget and the financial statements offer different perspectives which, when combined, can provide a fuller view of the costs of agency programs and of the government's commitments.

A view of the long-term sustainability of fiscal policies can also be helpful to decisionmakers considering the government's financial position and making decisions about resource allocation. Such a picture requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the implied commitments of social insurance programs—such as Social Security and Medicare—must be considered in addition to those items that are quantified in the financial statements. For example, if the combined Social Security trust funds' disbursements exceed receipts, as currently estimated to occur in 2012, the government's financing needs will increase. Since 1992, in a series of long-term simulations, we have analyzed various fiscal policy alternatives and their long-term sustainability.[8]

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[7] Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-101).

[8] The most recent of these reports are Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998) and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

Mr. HORN. So I thank the gentleman for a series of good questions, and now yield 10 minutes to my colleague from Texas, Mr. Sessions, the vice chairman of the committee.

Mr. SESSIONS. Mr. Chairman, thank you. First, I'd like to respond to my good friend from Ohio, Mr. Kucinich, when he talked about accurate historical significance. I would like to just, for the record, make sure that that's accurate historical review, and that is: this administration fought balancing the budget in all they could do; this administration, in my opinion, did not balance the budget. It was done because the Congress of the United States insisted that we balance the budget, and thank goodness the President did sign that balanced budget agreement, which is now the law of the land.

Mr. DeSeve, I appreciate your being here today. I think that, if the truth were known, that you and I in the performance of your duties, and mine, meet regularly. We get to see each other outside of you being a witness and raising your hand and swearing to tell the truth. And I want to thank you for the way you perform your duties, and the honesty and forthrightliness in which you present yourself, and I want to thank you for being here today.

Mr. DESEVE. Thank you very much.

Mr. SESSIONS. With that, in the spirit in which I've said that, I would like to ask that—Mr. Chairman, if it's OK—if we approach the witnesses to give them a copy of a document which is in our packets.

Mr. DeSeve, I would like to see, if you have not seen this sheet of paper, if you could look at it because what it talks about there, is it has the agencies broken down, and it talks about their financial management status, and the word has been used today, their statutory duties. And I wondered if you could take a minute and tell me the statutory duties of department heads and that that they have in relationship to financial management and status, and their performance of those duties.

Mr. DESEVE. Each department will be somewhat different, so let me speak generically and at a fairly high level, but try to cover your question. Every department head has to sign the FMFIA report which deals with internal controls. Every department head has to sign a representation letter regarding what they know about financial information, whether it's materially misleading in having come to their attention. So, they must be engaged in the audit process as the ultimate client.

In addition, the Inspector Generals continuously, in their own opinions, point out material weaknesses and reportable conditions, and under FMFIA, corrective action plans have to be put in place by each of the agency heads. I think those are their primary responsibilities along the way, from a statutory point of view, vis-a-vis financial management. And they're very serious responsibilities.

Mr. SESSIONS. Well I am, today, in looking at this, stunned, perhaps not surprised, but I have heard the number and I think it is truthful, but I could not swear to that, but that the Department of Justice has had a budget growth of 83 percent since the President has been our President. So, the Department of Justice budget has risen 83 percent, and yet I look at this sheet of paper, which you now have before you, and it says: Department of Justice, reliable financial information, no effective internal control, no compliance with laws and regulations, no grade in 1996, F grade in 1997, F. And it really brings about a question in my mind about who is and should be under the law. At this time, the Department of Justice has been engaged in going out and looking at private industry and they themselves in looking at other people who have perhaps violated the law, have not lived up to their spirit of accounting standards, have not done what I would consider to be statutory duties that a CEO may have.

And, yet, at this time, I've heard you describe that the Attorney General of the United States has to sign these forms that state that in her duties, statutory duties, that she's been in compliance, and yet we see here that the person who is able to go out and prosecute Americans gets an "F" and "no, no, and no," under their status report for their own fiscal accountability.

I'm disturbed. I'm disturbed and I think that this is nothing less than something that is intentional because year after year, they have received the "F" and I wonder how you can help me think through this person that's interested in the enforcement of the laws of this country, and they can sign a sheet, and yet an audit will show an F, and yet they are out prosecuting people in this country?

Mr. DESEVE. I want to be very clear about their signatures. Their signatures indicate not compliance, that they were compliant, but rather that their weaknesses, that there were things that happened, and they know of nothing else along the way. So, they don't indicate that they are compliant when they are not compliant. That's not what they do. They properly represent the fact that they are noncompliant——

Mr. SESSIONS. What they're stating is that that report, even if it says that they're not in compliance, is true to the best of their knowledge——

Mr. DESEVE. To the best of their knowledge, that is correct. I just want to be clear about that——

Mr. SESSIONS. Do you believe that it would be fair for the Department of Justice and the Attorney General of the United States to apply that same premise to someone involved in a SEC or other violations of this country dealing with financial management of a publicly held company?

Mr. DESEVE. I would stand corrected by my auditor friend on my left, but I think that every chief financial officer and every head of a public company has to make a similar set of representations when they have an audit done, and also, in their 10Ks—I believe their 10Ks and their 10Qs—have similar kinds of representations. So it's standard——

Mr. SESSIONS. Do you believe that in any manner that one of these people would be allowed to state, of all the deficiencies that they were aware of, and yet still sign that report, and year after year, still, this be allowed?

Mr. DESEVE. Yes, I'm going to again ask my colleagues to help me on this. I believe the first ever audit of the Justice Department was 1996. I believe they were a GMRA agency as opposed to a CFO Act agency. And the Department indicates that it's a big challenge, they're what we call a holding company department, they have lots of different pieces. And it's a big challenge with INS, it's a big challenge with the FBI, as it's a big challenge with many of their components to comply with the rigorous accounting standards as put in place. Their systems were not a priority designed for that purpose.

The Securities Act—and I'll ask now my colleague on my far right—of 1933, Mr. Murphy? Is that right?

The Securities Act of 1933 essentially set corporations on the course that we embarked on in 1996. So that applying a standard to a corporation is something that we've had experience with for some 60, 65 years. We believe that the Justice Department is working very hard, taking very seriously the work that it's trying to do, and trying to solve each of its problems. We've seen progress in its component agencies over the 2 years in which they've been required to do it.

So I don't think it's a lack of seriousness of purpose, I think it's simply a question of time before we get to that standard.

Mr. SESSIONS. I would just make the statement that those who throw stones should not live in glass houses.

I would like to now ask Mr. Hawke, if I could, please, there was a statement that was made by Mr. DeSeve about a bank card, and sir, I believe that you represent the Treasury Department, and part of the discussion that has taken place today, the word full cost was used as processes are looked at across government. And I am concerned, and would like to hear from you, about this bank card function. I think the statement was made that Treasury wants to make sure that no money leaves the Treasury that shouldn't. In other words, if it can be held within the Treasury, that would be done. And I am concerned, although I do not think I communicated directly with you, I am concerned about any Government agency doing something that is not cost effective and doing something that might be done more cost effectively by someone else. Can you please discuss with me this bank card?

Mr. HAWKE. Yes, I'd be happy to, Mr. Sessions. Let me first put it in context. What we're talking about here is accounting for intragovernmental transactions—that is, transactions in which one government agency is purchasing goods or services from another. The problem that was encountered in connection with the preparation of these consolidated financial statements is that there was no consistency in the way intragovernmental transactions were booked.

So you might have, for example, the Department of Defense making a purchase from the Government Printing Office, and the Government Printing Office may book that in the current period while the Department of Defense might book it in a future period, so they don't show up in the accounting in the same fiscal year.

Now that is being worked on; that problem is being worked on in a much broader context, with regard to the applicable accounting standards. But the credit card, the intragovernmental credit card, is also a way that we're going to be able to handle that problem——

Mr. SESSIONS. Does one not exist today?

Mr. HAWKE. There are some pilot programs that are in existence today, but we're moving toward a system in which the Department of Defense would be able to pay for that purchase from the Government Printing Office, for example, on a credit card so that—as Mr. DeSeve said—the money won't leave the Government but the accounting will be, in effect, simultaneously recorded because we'll have the two Government agencies as a party to a transaction——

Mr. SESSIONS. So, in other words, prior to today, there has not been or there has been a regular process, perhaps of the GSA, to pay for this, and to account for it?

Mr. MURPHY. We have some other systems. Years ago, we started out with just paper documents that both agencies signed, but then we started developing more automated systems that move the debits and credits between the agencies——

Mr. SESSIONS. In a timely manner.

Mr. MURPHY. In a timely manner, and simultaneously.

Mr. SESSIONS. OK.

Mr. MURPHY. Unfortunately, that system was not robust enough to provide all the accounting information along with the financial data that agencies needed to reconcile and identify what they were paying, and what accounts should be charged.

Mr. SESSIONS. Why is it being moved from GSA to Treasury? If you had an existing system, why did not GSA have an opportunity to go and make their system better? Why are you trying to duplicate or to do something?

Mr. MURPHY. At the moment—yes, sir. Basically, what we're doing is piloting two different applications at the moment to determine what works best. At some point we will go with one credit card application. We also will have some alternative mechanisms, including some mechanisms that utilize electronic data interchange, that agencies can use. So there may not be just one single system that does all intragovernmental transactions. In different cases, one may work better than another, and be more cost-effective.

Mr. SESSIONS. Well I do understand EDI and how it works. I am concerned about the duplication of this system and would like to, Mr. Hawke, speak with you perhaps later in the month, on that issue. I am concerned that tough questions have not been asked about this system and its performance, and the duplication of that, so——

Mr. MURPHY. We'd be happy to——

Mr. SESSIONS. I will do that offline and later. Mr. Chairman, thank you.

Mr. HORN. I thank the gentleman and am now delighted to yield to our valued colleague from South Carolina, Mark Sanford.

Mr. SANFORD. Thank you, Mr. Chairman. I have just a couple of questions to start with. In looking at the consolidated financial statement, when you walk away from the whole, in looking at the process, are you struck with, in other words, are you struck with a financial statement that suggests scarcity or otherwise?

Mr. DESEVE. Let me try to answer that question because I actually answered it the other day. I think the net position is approximately $5 trillion negative. I think when you take a $5 trillion negative and compare that to the nature of the economy of the United States——

Mr. SANFORD. Well, no, I'm not really going to the national debt. I guess what I'm suggesting is that as you'll look at $1.6 or $1.7

trillion being spent, and then you look at, as Congressman Armey had suggested earlier, a 200-year supply of raincoats, the loss of $875,000 tug boat, a $460,000 crane being misplaced, a couple of F–18 engines being lost—I had seen there, with the chairman's opening statement, you know, HCFA, basically overpaying by $23 billion or within the Social Security Administration, an additional $1 billion toward supplemental.

When you look at that sort of process—in other words—if you compare that to corporate financial statements that you've looked at, or individual financial statements that you've looked at, does it suggest to you scarcity or maybe too much money in Washington?

Mr. DESEVE. It suggests the need for a much better management of the resources that are there. I can't give you scarcity or surplus, but it's certainly bodes for better accountability of those resources.

Let me use HCFA as the example. I think you'll see this year that the $23 billion comes down to $20 billion. That's still not acceptable. Actually, it's a range——

Mr. SANFORD. That's real money, back home in South Carolina. [Laughter.]

Mr. DESEVE. Sir, yes, sir. It sure is in Pennsylvania where I come from. The auditors actually stated it as a range between $11 billion and about $24 billion this year. It's about 11 percent of HCFA's payments. It means that about 89 percent of the payments were made accurately; about 11 percent are inaccurate.

What that tells us as we begin looking at the reasons——

Mr. SANFORD. Have you seen that type of error rate in corporate financial statements you might have looked at?

Mr. DESEVE. I have not seen that type of error rate in corporate financial statements, and it's also higher than comparable Federal programs. I think we need to look very carefully at the fundamental nature of the programs, Medicare and Medicaid, and the logic behind their design.

They were designed as fast-pay programs. They were designed to quickly pay claims for doctors and hospitals without a pre-audit process built into them. The claims are paid by contractors. Contractors merely ascertain mathematical accuracy of a doctor's bill, by statute—by statute. And then they make the payment.

HCFA can go in on a post-audit basis. Doctors are very concerned now, the hospitals are very concerned, even in the post-audits the Department has begun, that there is going to be a lack of timely payment along the way. That their payments will be challenged and it will interrupt the payment flow. So we have to look at the logic of the system and the secretary——

Mr. SANFORD. You're saying, basically, that it's an illogical system?

Mr. DESEVE. I'm saying that Congress in legislating the way that the HCFA payment system worked, set up a criterion that was logical: Let's get these providers paid quickly so that we can hold their cost of funds down so that we can keep the system operating well. That was the logic of the system.

I'm not saying it is illogical. I'm suggesting the logic of a different system might say, let's do a pre-audit first. Let us set up some selective pre-auditing criteria. Let's pay 85 percent of the bill and then chase for 15 percent. There are lots of different logics that you could impose on that system——

Mr. SANFORD. If you were to look at the overall financial statement, you might not be able to make a determination as to whether there's too much money in Washington, or whether there was a scarcity of money in Washington, but what you would suggest, it seems to me, is, by what you said in terms of process, is clearly Washington at times is not setting its priorities. In other words, whether it's a 200-year supply of raincoats or a host of other things, that there is not a priority setting in the budgetary process in Washington. That would be a safe statement?

Mr. DESEVE. I think it goes even beyond the budgetary process because management is all about setting priorities and deciding what we should be doing and what we shouldn't be doing. I'll go back to the little homily example of the credit card. We don't need to be in the business of developing new financial management systems that are proprietary to the Federal Government. The Visa network can do the same kind of interchange, the same kind of transaction management that we do. We should take advantage of those commercial systems wherever we can. That's management, that's priority setting.

Mr. DODARO. Congressman, can I add something to this discussion?

Mr. SANFORD. Yes.

Mr. DODARO. The questions you're asking now are only possible because of the financial audits. For the first time, the government is quantifying the magnitude of these problems. Before the first financial audit of HCFA, everybody knew there were problems with Medicare overpayments and fraud and abuse, but only anecdotal information existed.

We worked, at GAO, with the HHS Inspector General to develop this sampling methodology to review paid claims. Now you have a measure to ask these questions and you have a measure that's now embedded in HCFA's performance plan to bring improper payment down. We didn't know before, as a government, how we were dealing with this, and where we should put our priorities. The estimate not only told us we had $23 billion of HCFA, it pinpointed types of providers where we were having a higher incidence of problems like, such as home health care providers. So, without these annual financial audits to track progress, you're not going to have the basis to ask those type of questions.

Mr. SANFORD. Following up on that very thought. In other words, in terms of tracking, where we are—we had a brief conversation earlier in this dialog, in accrual versus, basically, cost accounting. As I understand it, we run the Federal Government books on cost accounting period, correct?

Mr. DODARO. They've pretty much been run on a cash basis previously. We're trying to get them on an accrual basis with these financial statements.

Mr. SANFORD. So, in other words, as you look at accrual, I was looking at some of the numbers in the back of supplement here. For instance, if you look at Social Security, the numbers that are here seem to suggest that there was roughly about a $3 trillion liability with Social Security. Based on accrual accounting, we'd need to take that into account today. What do you think is the best way to—I mean, to have us recognize on a daily basis, for instance, the enormity of the Social Security problem? In other words, should we be—in other words, are we, in fact, on an accrual basis, not really running a surplus? If you take into account the contingent liability with Social Security?

Mr. MURPHY. Let me try to address that and then my colleagues can join in. At present, the accrual accounting standards that we have require for Social Security that the amount due and payable at the end of the year be shown as a liability on the balance sheet. In terms of those future liabilities for benefit payments, we disclose a great deal of information, both in the notes and in our stewardship section of the report.

Mr. SANFORD. I guess—let me turn it around. I guess what I'm asking is this: with the budget that the President sends every year to the Congress, basically, the formal debt of the U.S. Government is listed. What you all have done here is go a step further and listed the contingent liability that comes with Social Security. So you think it would be a good idea for this contingent liability to be listed as a part of our Federal budget?

Mr. DESEVE. Let me try to answer that one because I am from OMB. The budget rules, the scorekeeping rules, and the Budget Enforcement Act, and now the Balanced Budget Act—I'll use my word again—have a logic to them. You'd have to go back——

Mr. SANFORD. Can we go back, though? Would that be a yes or no on that last question? I just want to hear yes or no first.

Mr. DESEVE. I promise I'll give you a yes or no in just a second.

Mr. SANFORD. All right.

Mr. DESEVE. In order to do what you're suggesting, that is, use an accrual method and many State and local governments actually budget on a modified accrual basis, and it's only modified as to the timing of expenses and the timing of revenues. It's modified from straight accrual. They do use that in their budgeting.

The Federal Government has chosen not to do that——

Mr. SANFORD. Keep in mind the chairman has only given me 10 minutes, here, so—[laughter.]

Mr. DESEVE. I'm sorry. What the Federal Government has said is, here are the rules, here are the scorekeeping rules. In order to do what you're suggesting, we'd have to go back and unwind all of those rules. I think it's unlikely that we're going to want to do that any time soon. Collectively, when I say "we," I really mean the Congress and the administration.

So my answer is no, I think we have to deal with it as a liability, understand in the budget what our current payment is, and then spend a lot of time disclosing and discussing how we're going to fix the thing on a projected basis——

Mr. SANFORD. But wouldn't the budget be the best place to disclose it?

Mr. DESEVE. I think we can certainly disclose it, but to use it as a budgeting tool beyond what it is now, I think would require a tremendous change in our budgeting rules.

Mr. SANFORD. But, in other words, the numbers I just looked at here say that this contingent liability, if you include Medicare and

Social Security, is basically greater than the existing national debt that we recognize.

Mr. DESEVE. I'd have to do the math on that; I'm just not sure. We certainly need to have that out in front of everybody's eyes.

Mr. SANFORD. In the last few seconds that I have here—trying to squeeze it all in, Chairman.

On this last chart that was up here just a moment ago, it talked about 58 percent of the entities had received clean opinions. My question was, could we break that out in dollar terms? In other words, 58 percent of the entities might be a big part of the Government or it might be a little part of the Government. So, out of the $1.6 trillion or $1.7 trillion that we spend annually, what percent in dollar terms go clean opinions?

Mr. DESEVE. I need to do that for you because I haven't done it. It's 100 percent of the revenue. So, if you look at both sides of the budget, 100 percent of the revenue got a clean opinion because IRS is one of those 5 components. It's 100 percent of the debt. But I can't tell you what it is of the expenses, but I'll be happy to do that calculation on both the budget authority basis, and an outlay basis. We started to do it and we ran into some complications, but we can put that together.

Mr. SANFORD. And one last question, and that is, you've discussed at length goals for unqualified opinions, if you will. My question would be, what are we doing in terms of the next step, which is goals for effective systems that lock in a lot of these things we're talking about?

Mr. DESEVE. The chief financial officers that we referred to earlier have three primary goals. One of them is clean financial statements. The second is systems that make sense. Mr. Dodaro, Mr. Murphy and I all serve on the Joint Financial Management Improvement Project, which is setting the computer system standards and also is reaching out to find new and better ways to get the private sector to design good, workable systems for the Government. We have a schedule at GSA that folks buy off.

It takes time and, frankly, financial systems have a low priority within many organizations, believe it or not. This is helping to raise that priority. But most people would rather spend the extra dollar on programs rather than on system fixes, and that's true, in some cases, in congressional appropriations committees as well as within departments. So we continue to fight a battle to get the money for the systems. Luckily, computer costs are coming down and we're using more off-the-shelf software, and more commercial companies are coming into the Government market, all of which is going to be a tremendous help.

Mr. DODARO. Congressman, I would just add briefly that under the Federal Financial Management Improvement Act of 1996, if auditors determine the systems aren't in conformance with the standards that Mr. DeSeve just mentioned, the agency head has to submit a remedial plan to bring the agency in compliance with those system standards within a 3-year timeframe. So that also is forcing the agency head to deal with the deficiencies noted in the audit report with the ultimate goal of fixing the underlying financial systems, as well as getting clean opinions. That's another legislative tool.

Mr. SANFORD. Thank you, gentlemen. Thank you, chairman.

Mr. HORN. I thank the gentleman from South Carolina. We're going to go for a second round of 5 minutes each and I will yield my position and give the 5 minutes to my colleague, the ranking minority member, who has to leave for another subcommittee. Mr. Kucinich, 5 minutes.

Mr. KUCINICH. Thank you very much, Mr. Chairman. I do indeed have to go to a markup in the Education and the Workforce Committee. I would ask staff to put the chart up that plots the progress toward sound financial management. If you could do that, I'd be very grateful. Thank you.

I would just like to point out again, as you look at this chart, and we start with 1990, in 1990 you had about four agencies, major agencies, submitting financial statements, and about half of that receiving a clean audit. We go to 1994, the amount began to climb—actually triple to 12 agencies, major agencies, submitting financial statements, and the amount which received a clean audit doubled. And we go to 1996 and we have even more agencies, about 22 or 23 in 1996 submitting financial statements, and about a half-dozen receiving a clean audit. And in 1997, 24 major agencies submitting financial statements and about 8 to 10 receiving clean audit according to the chart on progress toward sound financial management.

And I think that progress is what needs to be the guiding word here, and progress involves trial and error, it involves pointing out the accomplishments, as well as pointing out what hasn't been done. Members of this committee have the right to point out what you need to do.

As we do that, I think it's fair to say, though, that the effort to bring the Government to better financial accounting doesn't mean that we suspend the administrative functions of the various departments which have some shortcomings in their financial accounting. I mean, imagine, for example, if we had a condition where a FBI agent, hot on the chase of the suspect suddenly cornered the individual and when he was about to make the arrest, was informed by the suspect, "Sir, the Department of Justice does not yet have its accounting straightened out so therefore you ought not arrest me." Now that would take that agent in shock of course, but the implications of any Federal agency suspending until their accounting would be done is interesting.

If we were to encounter Iraq, could you imagine how we were to respond if Saddam Hussein suddenly said to the Department of Defense, "Look, get your house in order, first, don't come after me."

We know that you have some things that you have to resolve and I commend the Chair of this committee and every member of this committee who puts you to the test to do it because you have to do it. But at the same time, with all due respect, there are statutory functions which must continue, obligations which the Government has constitutionally to exercise, notwithstanding the condition of accounting at some of the departments, which does need to be challenged and does need to be improved.

And with that, my dear friend the Chair, I'm going to have to go to my markup. But I thank you for your diligence in calling the administration to a higher standard of accounting because I think it's this process which enables us to move toward a more perfect union. Thank you.

Mr. HORN. I thank the gentleman. We have a few closing questions here. First, a very simple one. What did the audit cost? I realize we aren't done yet, but have you got a ballpark figure?

Mr. DODARO. Basically, the CFO Act requires OMB to report as part of their annual plan the cost of compliance with the act, so I know as Mr. DeSeve puts together the figures for this next year, it'll be included in that report to be submitted this summer.

The only thing I can speak to today, Mr. Chairman, are GAO's costs for doing this audit. For this fiscal year, as we focused on the 1997 audit, it costs us about $3–$3.5 million to audit the $1.7 trillion revenue collection activity of Internal Revenue Service and several hundreds of billions of dollars of accounts receivable which eventually got down to $28 billion which is collectible. It took about another $4 or 5 million for us to audit the $3.8 trillion at the Bureau of Public Debt, and the $242 billion interest payment on that debt, as well as the amounts, $1.6 trillion owed to the trust fund activities. And it cost us about maybe another, I'd say, $12 to $15 million to do—the computer control work, help support the IG's in doing some of the audits and covering the rest of the agencies across Government.

I would note a couple of things. One, we've issued quite a few reports on this effort in addition to the overall audit opinion which I'd be happy to supply for the record. Some of them are footnoted in the financial statement as well. We've issued, for example, a series of reports helping DOD focus on the environmental liability issue, focusing on what they need to consider in order to do that.

Also, we've been preparing for this for a number of years, and so in the 1996 process and earlier years, we engaged quite a bit with the Inspectors General across the Government to work on their activities, and actually, work jointly with a number of the IG's, particularly at HHS.

Mr. HORN. So, to sum it up, what would we say the estimated cost is? I won't hold you to it, but I'd just like a ballpark figure, and I'll give you, you know, a couple hundred million in either direction. [Laughter.]

Mr. DODARO. In my household, that bass boat is a material item, so I would like to provide that for the record, Mr. Chairman. I gave you GAO's costs for the year. I don't know, off-hand, the costs of all the Inspectors General.

Mr. DESEVE. We just haven't tabulated them for this year. They're still finishing up, as you indicated, with the incompletes. So we'll get those——

Mr. HORN. So what is the ballpark on this? See, what I can do is a simple thing. It cost us $3 million for the first audit in the history of Congress, 210-year history. So I can multiply 24 agencies by $3 million as a start, and say, did it cost you $72 million or did it cost $720 million, what was it? Where are we there?

Mr. DODARO. The only thing I can do is give you GAO's costs which I've given you, Mr. Chairman.

Mr. HORN. Give it to me as a bottom-line. I heard a lot of if's, and's, and but's there too, so what's the bottom-line?

Mr. DODARO. OK. Well the bottom-line for GAO for the year was about $20 million to carry out our activities. And that's without the costs of the IG's added to that figure. And it just wouldn't be fair for me to represent to you what their costs were.

Mr. HORN. Yes. No, no, we'll ultimately get that but I was just curious——

Mr. DESEVE. Mr. Chairman, the agencies would be, now that they've done a couple of them, would be significantly less than $3 million a copy for most agencies, for the normal agency. Where I can't speak is HHS and DOD. I know that there was some extraordinary costs in HHS for the sampling work they did and then the look-behinds.

And one of the problems—I'm not trying to be evasive, I just literally don't know. In some cases we have compliance auditing that's going on at the same time we're doing financial statement auditing.

HCFA's a classic example of that. They go in and they find in their sampling that there's a problem with a particular payment which would help them in the financial statement audit. They immediately begin the compliance process in that regard.

So, it will only take me a few days to get you the information, but I literally don't have it at hand. Certainly less than $720 million. If it's $72 million or $83 million——

Mr. HORN. I think I'm closer on the $72 million, right?

Mr. DESEVE. I think you're much closer on the $72 million, yes.

Mr. HORN. The Horn system of governmental accounting. No. 2—I've got two more questions—No. 2 is, I was very interested in what you had to say about the failure of the Department of Defense in the environmental area, because that's been bothering several hundred Members in the House and the Senate who say: "Look, when are they going to face up to their environmental responsibilities?" Now they've got offices over there at the secretary's level, they've got offices at the service level, and it seems to me part of the problem is their organization. Are they getting things done? Does GAO have any thoughts on that? Have you done an examination of that part of DOD?

Mr. DODARO. In the environmental area? Yes, we had a series of reports which I can provide for the record. Initially, the Department felt they didn't have the information necessary to make the calculations. We believed otherwise and embarked on a series of reports looking at different aspects, for example, in some of the submarines and some of the other areas. So we've issued a series of reports to them outlining the factors that they need to consider in coming up with the liabilities.

I believe they modified their accounting policies, and intend to try to report that for fiscal year 1998. We encouraged them to try to report in the 1997 timeframe in accordance with the standards, but that just didn't happen. So we've been giving that a lot of attention, and this is part of what we've been trying to do and part of our costs in carrying out this activity is to try to come up with solutions as well. We've been spending a lot of time at DOD trying to do that as well as helping them with their inventory counts and helping to try and improve accountability for mission assets.

Mr. HORN. Well, I think we're going to hold a hearing on this in the next 2 months because after reading this report, and the noting that you gave to this situation, I think Congress needs to say, "Hey, what's the problem? Is it just a failure of leadership? Is it a failure of organization?" They've got the money over there and they certainly get it out of us when they come; this is a very important thing.

So, my last point I want to make is that Mr. Sanford's questions were well taken, and I remember Mr. Neumann and I were the only people that talked about the future of liabilities 2 years ago in the House. And I've left it all to Mr. Neumann to keep up that crusade, but you had long-term planning, as I remember, in Social Security at about 70 years out, and you had the short-term at about 10 years out.

Now most of us know that we've got a really big problem in 2010 when you've got the baby-boomers hitting, and we're not going to have anymore the $1 billion surplus every week coming into that fund. It's going to go out.

We have a vote on the floor but we're going to be done in 2 minutes. So let me just say on Mr. Sanford's part, that what's pertinent here is that the accounting system which all of you have spent a lot of time improving is extremely important as we get the strategic plans in the right way, and, as you know, we've got a bill coming through, a law coming through on that, and redoing some of them.

And then getting the performance indicators. If the performance indicators are going to have any relevance and be able to enable a cabinet officer and the Office of Management and Budget and the President of the United States, who is the Chief Executive, to make optional choices, thus set priorities, we need the accounting system to go with the strategic plan to go with the performance indicators.

And so—I think I'm optimistic here—despite all the holes we can all pick around here—and we do; that's our job—things are improving. Let me just say in closing, I want to thank you all for coming here. I think it's been a very interesting discussion. If you have any last words to say about the GAO or the GAO about OMB and Treasury, feel free. We'll give you each about 30 seconds. Any comments?

Mr. DESEVE. I'll start and I'll say that I have not had a more pleasant relationship than the one I've had with Treasury and GAO. There's contentiousness but it's a contentiousness of ideas and a contentiousness of trying to solve problems, and I think that's been my experience, and I would defer to my colleagues.

Mr. DODARO. I would agree. I think we have a constructive working relationship. We call it as we see it, which is what we need to do at GAO, but we also need to step up and help find solutions to the problems, and we've been solution oriented. We're all after the same goal which is to give the public what they really deserve.

Mr. HORN. Well, I thank you, gentleman. Let me just note in conclusion, today's hearing is the first in a series of hearings during which the subcommittee will review the management practices and the financial management practices of the Federal Government. We have already scheduled the Internal Revenue Service for April 15—an interesting date, I might add; the Department of Defense on

April 16; the Health Care Financing Administration on April 17; the Inspector Generals as a group on April 21; the Clinger-Cohen procurement acquisition legislation and the flexibility we'll be looking at, on April 23; Federal property management we'll be looking at on May 4. So, in the next month, we have roughly six hearings on just this area, going into more depth.

And now let me thank the people that arranged this and are arranging those next six hearings: J. Russell George—whose back is against the wall there—stand up, Russell—staff director and chief counsel of the Government Management, Information, and Technology committee. The professional staff member that has worked particularly on this and explaining to us what's in those fine documents you gentlemen put out is Dianne Guensberg who is to my left and your right, she's on detail from the General Accounting Office; and we thank you, we're glad to have your experts come in here and we hope they learn something as we certainly learn something. John Hynes, professional staff member; Matthew Ebert, clerk; Welton Lloyd, a congressional fellow working with us; David Coher, a USC—let's see, not University of South Carolina, it's the University of Southern California as some know—as an intern, we're glad to have him; Kamela White also an intern. And then for the minority, we have Earley Green, the staff assistant for the minority; Mark Stephenson, professional staff member; Faith Weiss, minority counsel; and Ann Paine West is our court reporter. And we thank you all. With that, this hearing is adjourned.

[Whereupon, at 11:45 a.m., the subcommittee adjourned subject to the call of the Chair.]

[Additional information submitted for the hearing record follows:]

1997 Consolidated Financial Statements of the United States Government

Contents

A MESSAGE FROM THE SECRETARY OF THE TREASURY

I am pleased to present the fiscal year 1997 Consolidated Financial Statements of the United States Government — a truly historic undertaking. Never before has the United States Government attempted to assemble comprehensive financial statements covering all of its myriad activities and to subject those financial statements to an audit. I am confident that in future years, as the data used to prepare these financial statements continue to improve, these financial statements will prove to be an important management tool for policy-makers and the public.

The publication of these audited financial statements represents yet another stage in the Clinton Administration's continuing efforts to improve the management and efficiency of the United States Government. In 1994, the Administration strongly supported the Government Management Reform Act, which mandated the issuance of the audited financial statements which follow. The Administration has worked through the Federal Accounting Standards Advisory Board to create the accounting standards that form the basis for these financial statements.

Despite the substantial progress that has been made, however, further improvements are clearly necessary. The audit report from the General Accounting Office (GAO) discusses many areas in which the reliablity of the current financial statements must be enhanced and improved. As a result, the GAO was unable to render an opinion on these statements. The Administration is therefore committed to working with the GAO, Federal agencies, and other interested parties to achieve the President's goal of receiving an unqualified opinion from the GAO on the FY 1999 Consolidated Financial Statements. We believe that the publication of these audited statements is an important step in providing American citizens with more information about the operations of their government.

Robert E. Rubin

Consolidated Financial Statements of the United States Government, Fiscal 1997 Management's Discussion and Analysis: Introduction

No other entity in the world compares in size and scope to the U.S. Government, which has continuing responsibilities for the general welfare of its citizens and for national defense Yet, to this date, the U.S. Government has never set forth a comprehensive statement of its finances in accordance with applicable accounting standards. This document is the U.S. Government's first preparation, in accordance with new Federal accounting standards, of comprehensive financial statements that include all of its vast and complex activities and that subject those financial statements to the rigors of an audit. We are pleased that these financial statements have been produced and subjected to audit on a timely basis within the relevant statutory guidelines.

For over 200 years, effective management of the U.S. Government has suffered from a lack of comprehensive financial information. The Administration is committed to addressing this shortcoming. In 1994, the Administration strongly supported the Government Management Reform Act, which mandated the issuance of annual audited financial statements for the 24 largest agencies and for the Government as a whole. To provide a sound basis for these financial statements, the Administration and the General Accounting Office (GAO) have worked through the Federal Accounting Standards Advisory Board (FASAB) to create the accounting standards that form the basis for these statements.

> "No other entity in the world compares in size and scope to the U.S. Government."

The Administration appreciates the cooperation and assistance of the GAO in auditing these financial statements in a timely manner, and looks forward to working with the GAO, Federal agencies, and other interested parties to continue improving the reliability of the financial information upon which the statements are based. The effort to provide a comprehensive and reliable set of financial statements for the U.S. Government, which began in 1997, is ongoing and improvements are clearly necessary. Because of current data limitations, the GAO is not able to render an opinion on the reliability of these financial statements. The Administration is committed to improving the reliability of the financial information so that the U.S. Government can achieve the President's goal, as stated in the fiscal 1999 Budget, of receiving an unqualified opinion from the GAO on the fiscal 1999 Consolidated Financial Statements. In addition, the Administration's objectives for individual agencies are reflected in the Federal Financial Management Status Report and Five-Year Plan issued by the Office of Management and Budget. That document sets forth the dates by which agencies have pledged to submit timely financial statements with unqualified audit opinions.

The ongoing challenges involved in obtaining reliable financial information should not, however, obscure the progress that has been made or the potential insights provided by preparation and audit of these statements. The Administration remains committed to providing the President, the Congress, and the American people with reliable information about the financial position of the U.S. Government on an accrual basis — including the cost of its operations and the financing sources used to fund these operations. Such information will ultimately prove extremely helpful to policy-makers and the public.

It is worth emphasizing that the U.S. Government does not have a single bottom line that reflects its financial status. Its operations and scope are much too complicated to be summarized in any single number. But the information included in these statements provides a view of the Government's finances that has not previously been presented in a comprehensive form.

The accompanying financial statements are required by 31 U.S.C. 33 (e)(1) and consist of Management's Discussion and Analysis (MD&A), a Balance Sheet, a Statement of Net Cost, a Statement of Changes in Net Position, Notes to the Financial Statements, and Supplementary Information, which includes a stewardship section. Each section of these financial statements is preceded by a description of the section's contents.

Management's Discussion and Analysis

This section explains the basis of accounting used to prepare the statements and presents selected financial and economic information intended to assist readers in their assessment of the U.S. Government's financial status. It also summarizes financial management initiatives designed to continue improving the reliability of the financial statements and to address the issues identified in GAO's report on these financial statements.

Reporting entity and basis of accounting

Coverage

The financial statements cover the executive branch, as well as parts of the legislative and judicial branches of the U.S. Government. Information from the legislative and judicial branches is limited because those entities are not required to prepare comprehensive financial statements. For example, the property, plant and equipment of the judicial branch and the Congress are not reflected in these statements. In addition, government-sponsored enterprises (such as Federal Home Loan Banks and the Federal National Mortgage Association) are excluded because they are privately owned. The Federal Reserve System is also excluded because monetary policy is conducted separately from and independently of the other central Government functions. The narrative associated with the Statement of Net Cost describes the major functions of the U.S. Government.

Accounting standards

In 1994, Congress passed and the President signed the Government Management Reform Act, which required the preparation and audit of financial statements. At that time, the U.S. Government did not have a comprehensive set of generally accepted accounting standards. The three principals concerned with overall financial management in the U.S. Government (the Secretary of the Treasury, the Director of OMB, and the Comptroller General) created the FASAB to address this void. Just as the effort to improve the reliability of the financial statements is ongoing, the effort to produce and implement a comprehensive set of accounting principles is also ongoing: FASAB completed work on the basic set of Federal financial accounting standards (FFAS) in 1996, but some of the standards will not become effective until fiscal years 1998 and 1999.

The accounting standards developed by FASAB are tailored to the Federal Government's unique characteristics and special needs. For example, the U.S. Government needs financial information that is useful in planning future budgets and in controlling budgetary expenditures. Consequently net costs, rather than profit, are used as the primary financial measure for assessing efficiency and effectiveness of Government operations.

"The Administration remains committed to providing the President, the Congress, and the American people with reliable information about the financial position of the U.S. Government."

The Consolidated Financial Statements of the U. S. Government are generally prepared in accordance with applicable FFAS. The statements are on the accrual basis unless otherwise noted. Thus transactions are recorded in the accounting records when the events giving rise to the transactions occur, rather than when cash is received or paid. By contrast, the Federal budget is generally based on budgetary concepts and policies adopted by the Congress and the Executive branch, which are generally on the cash basis.

"The accounting standards developed by FASAB are tailored to the Federal Government's unique characteristics and special needs."

The most significant difference between FFAS and budgetary measures involves timing and other differences between the recognition and measurement of revenues and costs. For example, accounting standards require recognition of liabilities for costs related to environmental clean-up when the events resulting in such costs occur. By contrast, only the amounts expended currently are included as outlays in the budget. The effects of these differences are reflected in the "Reconciliation of the Changes in Net Position to the Deficit on the Budgetary Basis," which is presented in the supplementary section of these financial statements.

These financial statements do not include information on natural resources (depletable resources, such as mineral deposits and petroleum or renewable resources, such as timber) because standards have not yet been recommended for recognizing and measuring these assets. Nor are values for stewardship land (land not used in Government operations) included in these financial statements — information about the composition and quantity of such land is, however, reported in the stewardship section in accordance with FFAS.

Finally, a comprehensive assessment of the Government's financial status should recognize the Government's sovereign powers to raise revenue and regulate commerce. These powers are not reflected in the following statements, but should be considered in a comprehensive assessment of the Government's financial condition.

Future changes

As noted above, the process of improving these financial statements is ongoing. For example, in future financial statements, FASAB is proposing that the value of national defense property, plant, and equipment (weapons systems and support property used in the performance of military missions and vessels held as part of the National Defense Reserve Fleet) be removed from the balance sheet and that information about these assets be reported in the stewardship section of the financial statements. These assets are currently valued at $636 billion. In addition, future financial statements will include information about deferred maintenance (maintenance that was not performed when it should have been or was scheduled).

The 1998 financial statements will also expand the stewardship section, which will include a current services assessment showing both the short- and medium-term direction of current programs. The current services assessment will present actual receipt and outlay data for all programs for the year for which the financial statements are prepared (the base year) and estimates for at least six years subsequent to the base year. This assessment will thus facilitate evaluation of the sufficiency of future resources to sustain public services and to meet current and future obligations as they become due.

"The 1998 financial statements will include a current services assessment showing both the short- and medium-term direction of current programs."

The stewardship section of these financial statements in future years will also include information about heritage assets and stewardship investments. Heritage assets are national monuments, museums and library collections. Stewardship investments include:

•Non-federal physical property: the Federal share of properties owned by State and local governments (e.g. highways and airports).

•Human capital: Investments in education and training programs financed by the Federal Government for the benefit of the public.

•Research and development: Federal Government investments in basic and applied research and development.

These investments will be separately identified in the stewardship section, but will not be reported on the Consolidated Balance Sheet.

Economic and budgetary results

Economic conditions were extremely favorable in fiscal 1997. Over the year ending in September, the rate of growth of economic activity accelerated, job gains continued to be very strong, and the unemployment rate fell to 24-year lows. At the same time, inflation was very well contained, with the underlying rate of inflation dropping to levels not seen since the mid1960's. Strong growth in incomes contributed to a decline in the Federal budget deficit to its lowest level since 1974.

"Over the year ending in September, the rate of growth of economic activity accelerated, job gains continued to be very strong, and the unemployment rate fell to 24-year lows."

The economy in fiscal 1997

Real gross domestic product (GDP) grew by 3.9 percent during fiscal 1997 (which encompasses the fourth quarter of calendar 1996 through the third quarter of calendar 1997), the fastest rate of growth since fiscal year 1984. Growth was strongest in the first two quarters of the fiscal year at a more than 4 percent annualized pace, then it moderated to close to a 3 percent annualized rate in the second half of the year.

The economy was led by strong gains in consumer spending and in business capital investment. Consumer spending, which accounts for about two-thirds of real GDP, expanded by 3.8 percent during the fiscal year, much faster than the 2.4 percent average pace in the prior two fiscal years. Business investment spending grew by 10.8 percent during fiscal 1997, chiefly due to continued strong gains in spending on capital equipment such as computers and other high technology goods. Residential construction started the fiscal year on a weak note but strengthened over the course of the year, posting a modest 2.2 percent increase for the year as a whole. Restraining growth in fiscal 1997 was further deterioration in net exports, as accelerating domestic economic growth continued to draw in imports at a faster pace than the growth in exports.

Employment growth accelerated in fiscal 1997 as the economy added 2.8 million new jobs, compared with gains of 2.4 million and 2.6 million for the previous two fiscal years. Most of the new jobs were in the private service-producing sector, with especially rapid growth in business and engineering and management services. Employment in manufacturing increased by 126,000 in fiscal 1997, and construction jobs grew by more than 200,000 due to a pickup in both residential and nonresidential building. The unemployment rate fell below 5 percent at the end of the fiscal year and averaged 5.1 percent for the year as a whole. These rates were the lowest rates of unemployment in 24 years.

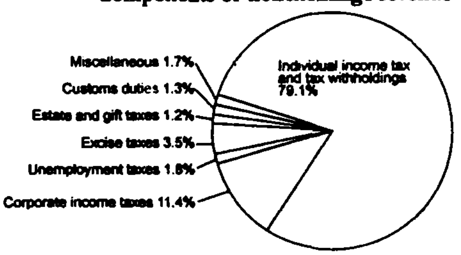
Despite healthy economic growth and very low rates of unemployment, price pressures did not build up during the year; indeed, if anything, inflation declined. Broad measures of inflation remained extremely low, rising at rates not seen since the mid-1960's. Lower energy and food prices played a role in holding inflation down, as prices for these commodities eased after some pickup in the prior year. Prices for other goods and services were also well-contained. Total consumer prices increased by 2.2 percent during the fiscal year and "core" prices (excluding the food and energy components) also rose a modest 2.2 percent. In fiscal 1996, in contrast, total consumer prices increased by 3.1 percent and the underlying ("core") rate of inflation was 2.6 percent.

Budget results

The Federal budget deficit improved dramatically in fiscal 1997, falling to $22 billion from $107 billion a year earlier. The 1997 deficit was the lowest in more than two decades, and continues the substantial progress made over the past few years in reducing the deficit. Since reaching an all-time high of $290 billion in fiscal 1992, the deficit has been cut by almost 90 percent over the past five years. As a share of GDP, the deficit now stands at 0.3 percent, the lowest percentage since fiscal 1969, when the budget was last in surplus.

The fiscal 1997 deficit was well below the deficit that was forecast at the start of the fiscal year, due in large part to higher-than-expected receipts, which increased by 8.7 percent in fiscal 1997. Growth of receipts was led by strong gains in individual income tax payments, reflecting rapid job and income growth as well as high levels of capital gains from the rising stock market. Corporate income tax receipts also grew rapidly as profits continued to rise.

Components of nonexchange revenue



Growth of outlays was just 2.7 percent in fiscal 1997, held down in part by spectrum auction proceeds and inflows to the deposit insurance account, both of which are netted against outlays in budget accounting. Excluding those two

> **"The Federal budget deficit improved dramatically in fiscal 1997, falling to $22 billion from $107 billion a year earlier."**

categories, growth of outlays in fiscal 1997 was approximately 3.5 percent, still a very moderate increase. Most categories of outlays posted only modest increases in spending compared with the previous year, except for defense and a few small programs, which grew at slightly faster rates.

Improvements in the deficit have continued into fiscal 1998. The Federal Budget for fiscal 1999 projects the budget to show a $10 billion deficit in fiscal 1998 — followed by a nearly $10 billion surplus in fiscal 1999, which would be the first surplus in 30 years. Some outside analysts believe that results so far through the current fiscal year suggest that the fiscal 1998 budget may actually post a surplus — which would be the first in 29 years — instead of a small deficit.

Revenue and expense summary

Revenue

Nonexchange revenue is the U.S. Government's primary source of revenue, and totaled $1,577 billion in 1997. More than 95 percent of this total came from tax receipts, with the remainder coming from customs duties and other miscellaneous receipts.

Earned revenues are inflows of resources that arise from exchange transactions. Exchange transactions occur when each party to the transaction sacrifices value and receives value in return — for example, when the U.S. Government sells goods or services to the public. During 1997, the Government earned $158 billion in such revenue. These revenues are offset against the gross cost of the related functions to arrive at the function's net cost. The U.S. Government also earned $12 billion that was not offset against the cost of any function.

Expenses by function

The net cost of U.S. Government operations was $1,603 billion for 1997. Net cost represents the gross cost of operations less attributable earned revenues. The statement of net cost reflects the cost incurred to carry out the national priorities identified by the President and the Congress. The functions and subfunctions used to accumulate costs associated with the national priorities are identified in the President's budget and described in detail in the Consolidated Financial Statements section of this report. The accompanying chart presents the percentage of the net cost of Government operations represented by each of the U.S. Government's functions.

Asset and liability summary

Assets

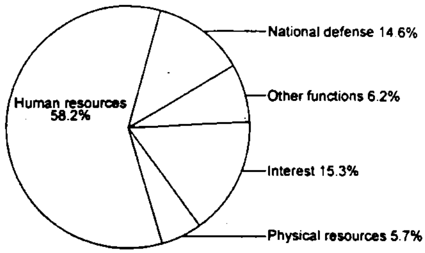
The assets of the U.S. Government are the resources available to pay liabilities or to satisfy future service needs. The assets presented on the balance sheet are not a comprehensive list of Federal resources. For example, the Government's most important financial resource, its ability to tax and regulate commerce, cannot be quantified and is not reflected. Natural resources and stewardship land (national parks, forests and grazing lands) are other examples of resources that are not included in the $1,602 billion of Federal assets reported at the end of 1997. The accompanying chart depicts the major categories of reported assets as of September 30, 1997 as a percentage of reported total assets. Detailed information about the components of these asset categories can be found in the notes to the financial statements.

Liabilities

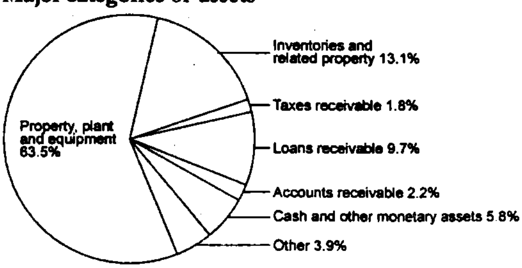
At the end of 1997, the U.S. Government reported liabilities of $6,605 billion. These liabilities are probable and measurable future outflows of resources arising out of past transactions or events. The largest component of these liabilities ($3,768 billion) is represented by Federal debt securities held by the public. The next largest component ($2,244 billion) relates to pension, disability, and health care costs for veterans, and retired military and Federal employees.

Another liability, which will likely require substantial future budgetary resources to liquidate, is related to environmental clean-up costs. As of September 30, 1997, the cost of cleaning up environmental contamination was estimated to be $212 billion. This figure is subject to much uncertainty, however, for two reasons. First, it does not include complete estimates from all agencies with likely environmental clean up responsibilities. Second, agencies lack substantial experience in estimating clean-up costs. Therefore it is likely that the liability estimate will be revised as agencies gain experience in identifying and estimating environmental clean-up costs. The accompanying chart presents

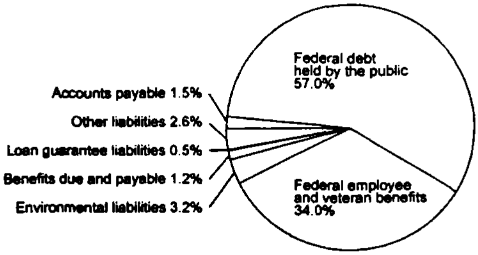
Net cost by major function



Major categories of assets



Major categories of liabilities



the percentage of total Federal liabilities represented by each of the categories of liabilities reported on the balance sheet. Additional details about the U.S. Government's reported liabilities can be found in the notes to the financial statements.

Future commitments

The U.S. Government has substantial future commitments to its citizens, including the provision of social insurance through the Social Security and Medicare programs and other commitments associated with Federal insurance and loan programs. Information about the nature and extent of these commitments is presented below.

Financial condition of the Social Security trust funds

Two trust funds have been established by law to finance the Social Security program (OASDI) -Federal Old Age and Survivors Insurance (OASI) and Federal Disability Insurance (DI). OASI pays retirement and survivors benefits and DI pays benefits after a worker becomes disabled. OASDI revenues consist of taxes on earnings that are paid by employees, their employers, and the self-employed. OASDI also receives revenue from taxation of part of Social Security benefits. Revenues that are not needed to pay current benefits or administrative expenses are invested in Treasury securities to earn interest for the trust funds. The securities issued to the trust funds are guaranteed as to both principal and interest and backed by the full faith and credit of the U.S. Government. All else equal, the issuance of securities to the trust funds reduces the amount Treasury must borrow from the public. Conversely, when the trust funds need cash, they redeem investments and raise the financing requirements of the Treasury (again, all else equal).

The Board of Trustees of the OASI and DI Trust Funds provides the President and the Congress with short range (10 years) and long range (75 year) actuarial estimates of each trust fund. Because of the inherent uncertainty in estimates for as long as 75 years into the future, the Social Security Trustees use three alternative sets of economic and demographic assumptions to show a range of possibilities. Most analysts use the intermediate set of assumptions to evaluate the financial condition of the Social Security program.

The 75-year estimates assume that future workers (except for those working in types of employment not mandatorily covered by the program) are covered by Social Security once they enter the labor force. The estimates reflect the impact of the retirement of the baby boomers, as well as changing demographics (e.g. an increase in life expectancy and a decline in the birth rate). For example, in 1960, 5 workers paid for every beneficiary. Today, the ratio of workers to beneficiaries is 3.3 to 1 and 30 years from now, when the baby boom generation retires, it will drop to 2 to 1. The retirement component of the program is financed largely on a "pay-as-you-go" basis, i.e., current retirement benefits are largely financed by current payroll contributions.

"The Administration intends to work with Congress on a bipartisan basis to enact long-term Social Security reform in 1999."

Under current legislation and using intermediate assumptions, the Trustees estimated in their 1997 report that by 2012 cash disbursements for the programs will exceed cash receipts and by

2029 the combined trust funds assets, primarily investments in Treasury securities, will likely be exhausted. With no change in the program, in 2012 the trust funds are expected to begin using interest on their investments to cover the cash shortfall and to pay benefits. Starting in 2019, they would begin redeeming their investments in Treasury securities to provide the needed cash. In 2029 trust fund assets would be exhausted; at that time, tax revenues would be sufficient to pay approximately 75 percent of the benefits due. In these consolidated financial statements (which eliminate intragovernmental assets and liabilities), the OASDI cash shortfall would result in a decrease in cash and/or an increase in amounts borrowed from the public.

After a year of public discussion in 1998, the Administration intends to work with Congress on a bipartisan basis to enact long-term Social Security reform in 1999. Acting sooner rather than later to address the long-term financing needs of the program will make the required changes less disruptive and ensure that Social Security works as well for future generations as it has for past generations. Additional information about the Social Security program can be found in the stewardship section of these financial statements.

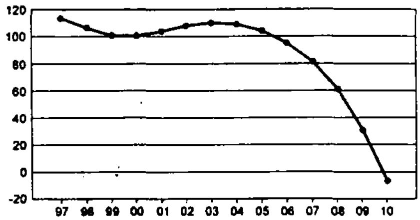
Financial condition of the medicare trust funds

Two trust funds have been established to finance the Medicare program. The Medicare Part A Hospital Insurance (HI) Trust Fund is financed by a 2.9 percent tax on wages and salaries required to be paid equally by employees

"The Federal Government has significant commitments associated with Federal insurance and loan programs."

and employers. The Medicare Part B Supplementary Medical Insurance (SMI) Trust Fund receives premium payments on behalf of Medicare beneficiaries who have elected coverage. These premiums covered approximately 25 percent of the fund's costs in fiscal 1997. The remainder of the costs is funded by Congressional appropriations.

Federal Hospital Insurance end of year Trust Fund balances through 2010 (In billions of dollars)



The 1997 trustee's report projected that the HI trust funds' assets were expected to be depleted by 2001. However, the Balanced Budget Act of 1997, which was enacted after the trustee's report was issued, contained provisions that reduce the growth of the programs' costs. As a result of the Balanced Budget Act of 1997, the HI trust fund assets are not expected to be depleted until 2010. That legislation also established a bipartisan commission to assess and recommend structural changes to ensure Medicare's long term viability. The Commission is required to issue its report by March 1999. The accompanying chart presents the end of year HI trust fund balances. Additional information about the Medicare program can be found in the stewardship section of these financial statements.

Other commitments

The Federal Government has significant commitments associated with Federal insurance and loan programs. These programs include bank deposit insurance, national flood insurance, federal crop insurance, and a range of other insurance commitments that total over $2,774 billion. In addition, the U.S. Government has guaranteed a substantial portion of this country's housing, agriculture and education loans. Although the face value of these guarantees was in excess of $712 billion as of September 30, 1997. The amounts reported for insurance and loan commitments represent the most conservative possible assumptions of maximum risk exposure. These amounts are not future claims on Federal resources. However, the risk of future outlays associated with such commitments could be substantial. Additional details about the U.S. Government's future commitments are presented in the notes to the financial statements.

Management initiatives

Since passage of the CFOs Act in 1990 and its expansion in 1994, much has been accomplished. There is now a comprehensive set of generally accepted accounting standards in place. For the first time in its history, the U.S. Government has prepared and subjected to audit consolidated financial statements covering all its vast and complex programs and activities. The 24 agencies subject to the CFOs Act are issuing audited agency-wide financial statements. Government corporations subject to the Government Corporation and Control Act also are issuing audited financial statements. While these accomplishments are significant, they are just a beginning.

"The Administration has designated financial management as one of the President's priority management objectives."

The Administration has designated financial management as one of the President's priority management objectives. The Administration has expressed its commitment to assuring the integrity of Federal financial information and gaining an unqualified opinion on the 1999 Consolidated Financial Statements of the U.S. Government. For the Administration to achieve these objectives, agencies must improve the quality of their financial information.

Reflecting the further progress that is needed to produce reliable financial statements, auditors were unable to render an opinion on the consolidated financial statements of the U.S. Government because accurate information about the amount and value of certain assets, liabilities, and costs was lacking. Actions to correct these weaknesses have been identified and are being implemented. For example, plans at Defense include completing a new accounting systems architecture, reviewing inventory accounting processes, and developing a department wide property accountability system. OMB, Treasury, and GAO are working with the major credit agencies to improve reporting of loans and loan guarantees.

In addition, Treasury plans to step up its efforts with agencies' to ensure effective cash disbursement reconciliations by providing frequent analysis of cash reciept and disbursement differences so that they can be promptly resolved.

Treasury and OMB are coordinating efforts to resolve the problems agencies are having in eliminating transactions between Federal agencies. Treasury and OMB will strengthen guidance and requirements for agencies to capture information needed to reconcile balances with their Federal trading partners. Treasury will also begin the modification of its systems to support agency efforts.

In an effort to determine the full extent of improper payments that occur in major Federal programs, the OMB is working with the GAO, Inspectors General and affected Federal agencies in identifying at risk programs and designing a cost effective approach to assessing the extent of improper payments and appropriate remediation measures. Audits of Federal programs pursuant to the Single Audit Act Amendments of 1996 and OMB Circular A-133, "Audits of States, Local governments, and Non-Profit Organizations," will be the principal mechanism for assessing the extent of improper payments.

Finally, Treasury will increase its formal and informal training of agency financial management personnel. The training will address common errors identified in agency information used in the preparation of the U.S. Government's 1997 consolidated financial statements.

Year 2000 Conversion

The Year 2000 problem presents the most sweeping and urgent information technology challenge faced by public and private organizations since the beginning of the information technology era. For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data and storage space and reduce operating costs. In this format, 2000 is indistinguishable from 1900 because both are represented as "00". As a result, if not modified, computer systems or applications that use dates or perform date/time sensitive calculations may generate incorrect results beyond 1999.

"The Year 2000 problem presents the most sweeping and urgent information technology challenge faced by public and private organizations since the beginning of the information technology era."

The Administration has devoted a great deal of time and attention to this issue. OMB requires Federal agencies to report quarterly on their progress in addressing the issue of year 2000 conversion. More recently, the President has established a council on Year 2000 Conversion led by an Assistant to the President. This person will oversee Federal preparations, speak for the United States in national and international forums, and coordinate with governments at all levels.

The U.S. Government's strategy for resolving the Year 2000 problem has five phases: awareness, assessment, renovation, validation, and implementation. The milestone for completion of work for the renovation phase is targeted for September 1998. Other milestones are January 1999 for validation and March 1999 for implementation. Priority is being given to the 7,850 "mission critical" systems. As of February 15, 1998, OMB estimated that 35 percent have been fixed, about 45 percent still need to be repaired, 15 percent will be replaced and 5 percent will be retired. OMB is monitoring agency progress and taking actions necessary to ensure milestones are met. The latest cost estimate for corrective actions, provided by agencies to OMB, is nearly $5 billion.

Additional Information

Additional details about the information contained in these financial statements can be found in the financial statements of the individual agencies listed in the Appendix. In addition, related U.S. Government publications such as the "Budget of the United States Government", the "Treasury Bulletin," the "Monthly Treasury Statement of Receipts and Outlays of the United States Government," and the Trustee's reports for the Social Security and Medicare programs may be of interest.

Comptroller General
of the United States

Washington, D.C. 20548

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March 31, 1998

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

The Chief Financial Officers (CFO) Act, as expanded by the Government Management Reform Act, mandates important reforms in federal financial management to promote greater accountability in managing the finances of our national government. Among these reforms are requirements for the preparation and audit of individual financial statements for the federal government's 24 largest departments and agencies and the annual submission of consolidated financial statements for the U.S. government. GAO is required to audit the consolidated statements, and our first report is enclosed.

These reforms are leading to marked improvements in federal financial management. Several major agencies have made good progress in producing more reliable financial information about their operations. However, as outlined in our report, improvements in other areas of government financial operations have yet to be made and critical governmentwide accounting issues still need to be addressed. The federal government can achieve the fiscal accountability called for by the CFO Act, but strong leadership, commitment, and additional concerted effort will be necessary.

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

James F. Hinchman

James F. Hinchman
Acting Comptroller General
of the United States

GAO United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

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

The Chief Financial Officers Act, as expanded by the Government Management Reform Act, requires the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, to annually submit to the President and the Congress audited consolidated financial statements of the U.S. government beginning with those for fiscal year 1997. GAO is required to audit these statements.

In summary, significant financial systems weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, prevent the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the reliability of the consolidated financial statements and much of the underlying financial information. They also affect the government's ability to accurately measure the full cost and financial performance of programs and effectively and efficiently manage its operations. Major problems included the federal government's inability to

—properly account for and report billions of dollars of property, equipment, materials, and supplies;

—properly estimate the cost of most federal credit programs and the related loans receivable and loan guarantee liabilities;

—estimate and report material amounts of environmental and disposal liabilities and related costs;

—determine the proper amount of various reported liabilities, including postretirement health benefits for military and federal civilian employees, veterans compensation benefits, accounts payable, and other liabilities;

—accurately report major portions of the net costs of government operations;

—determine the full extent of improper payments that occur in major programs and that are estimated to involve billions of dollars annually;

—properly account for billions of dollars of basic transactions, especially those between governmental entities;

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—ensure that the information in the consolidated financial statements is consistent with agencies' financial statements;

—ensure that all disbursements are properly recorded; and

—effectively reconcile the change in net position reported in the financial statements with budget results.

Such deficiencies prevented us from being able to form an opinion on the reliability of the accompanying financial statements. They are the result of widespread material internal control and financial systems weaknesses that significantly impair the federal government's ability to adequately safeguard assets, ensure proper recording of transactions, and ensure compliance with laws and regulations. Additionally, (1) serious computer control weaknesses expose the government's financial information to inappropriate disclosure, destruction, modification, or fraud and (2) material control weaknesses affect the government's tax collection activities. Further, tests for compliance with selected provisions of laws and regulations related to financial reporting disclosed material instances of noncompliance discussed later in this report.

Our audit of the federal government's consolidated financial statements and the Inspectors General (IG) audits of major component agencies' financial statements for fiscal year 1997 have resulted in (1) an identification and analysis of deficiencies in the government's recordkeeping and control systems and (2) recommendations to correct them. Fixing these problems represents a significant challenge because of the size and complexity of the federal government and the discipline needed to comply with new accounting and reporting requirements.

Considerable effort is already underway to make such improvements. Several individual agencies that have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them. With a concerted effort, the federal government, as a whole, can continue to make progress toward generating reliable information on a regular basis. Annual financial statement audits are essential to ensuring the effectiveness of the improvements now underway.

This report provides our (1) disclaimer of opinion on the government's fiscal year 1997 consolidated financial statements, (2) report on internal controls, and (3) report on compliance with selected provisions of laws and regulations related to financial reporting. It also presents information on (1) the Year 2000 computing problem, (2) issues affecting the government's long-term financial condition, and (3) actions underway to improve financial reporting across the federal government. The objectives, scope, and methodology of our work are discussed in the appendix

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to this report. We provided a draft of this report to senior Department of the Treasury and Office of Management and Budget (OMB) officials, who expressed their commitment to address the deficiencies this report outlines. Our work was done in accordance with generally accepted government auditing standards.

DISCLAIMER OF OPINION

Because we were unable to determine the reliability of significant portions of the accompanying consolidated financial statements for the reasons described above, we are unable to, and we do not, express an opinion on the accompanying consolidated financial statements for fiscal year 1997. However, we were able to determine that amounts reported for environmental and disposal liabilities and liabilities for veterans compensation benefits are understated by material amounts.

Additionally, certain agencies have not, at this date, finalized their individual financial statements for fiscal year 1997. It is possible that additional recordkeeping and auditing procedures will result in changes in those agency statements. Based on the audit procedures we have performed, we are satisfied that any such changes will not significantly affect our findings and conclusions in this report.

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

Material Deficiencies

The following sections describe material deficiencies we identified and discuss their effect on the financial statements and the management of government operations.

Property, Plant and Equipment and Inventories and Related PropertyThe federal government—one of the world's largest holders of physical assets—does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than $1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records. These include (1) operating materials and supplies comprised largely of ammunition, defense repairable items (such as navigational computers, landing gear, and transmissions), and other military supplies and (2) buildings, military equipment, and various government-owned assets in the hands of private sector contractors.

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Because the government does not have complete and reliable information to support its asset holdings, it could not satisfactorily verify the existence of all reported assets, substantiate the amounts at which they were valued, or determine whether all of its assets were included in its financial statements. For example, certain recorded military property had, in fact, been sold or disposed of in prior years—or could not be located—and an estimated $9 billion of known military operating materials and supplies were not reported. These problems impair the government's ability to (1) know the location and condition of all its assets, including those used for military deployment, (2) safeguard them from physical deterioration, theft, or loss, (3) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (4) determine the full costs of government programs that use the assets.

Loans Receivable and Loan Guarantee Liabilities Most federal credit agencies responsible for federal lending programs were unable to properly report the cost of these programs. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, small business, veterans' mortgages, and student loans. As of the end of fiscal year 1997, the government reported $156 billion of loans receivable and $37 billion of liabilities for estimated losses on defaulted guaranteed loans. However, the net loan amounts expected to be collected and guarantee amounts expected to be paid could not be reasonably estimated because of a lack of historical data or other evidence. In addition, some agencies did not have adequate information to support the validity of their outstanding direct loans or to track the specific loans that they have an obligation to guarantee. Until federal credit agencies correct these serious data deficiencies, information supplied by them about the cost of their credit programs, including information to support annual budget requests for these programs, should be used with caution in making future budgetary decisions, managing program costs, and measuring the performance of credit activities.

Environmental Liabilities Liabilities for disposal of hazardous waste and remediation of environmental contamination, reported at $212 billion, were materially understated primarily because an estimate has not been developed for major weapons systems, such as aircraft, missiles, ships and submarines, and for ammunition. Properly stating these liabilities could assist in determining priorities for cleanup activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities.

Liabilities The systems and data were not available to accurately estimate significant portions of the more than $2.2 trillion reported as federal employee and veterans benefits liabilities. For example, to estimate the $218 billion reported as military postretirement health benefit liabilities, the government used unaudited budget information because the necessary cost data were not available. Also, the federal government cannot provide adequate assurance about the reliability of historical claim information at the insurance carrier-level used to estimate the $159 billion reported for

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civilian postretirement health benefit liabilities. Additionally, the estimated liability for veterans compensation benefits is materially understated because it does not include estimates for anticipated changes in disability ratings and for incurred claims not yet reported. In addition, some agencies do not maintain adequate records and controls or have systems to ensure the accuracy and completeness of data used to calculate estimates of a reported $98 billion of accounts payable and a reported $169 billion of other liabilities such as those for litigation.

These problems significantly affect the determination of the full cost of the government's current operations, as well as the extent of actual liabilities. Further, commitments and contingencies were not properly reported because many amounts represent the maximum risk exposure rather than the amount of loss that is reasonably possible and certain commitments are not reported.

<u>Costs of Government Operations</u> The government was unable to support significant portions of the more than $1.6 trillion reported as the total net costs of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective reconciliations, as discussed below, also affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost categories reported in the Statement of Net Cost and in the subfunction detail following the statement were properly classified. Without accurate cost information, the federal government is limited in its ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required.

The government is also unable to determine the full extent of improper payments—that is, payments made for other than valid, authorized purposes. In this regard, estimates of improper payments in major federal programs, such as Medicare, total in the billions of dollars annually. The full extent of such payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs. The reasons for improper payments range from mistakes to fraud and abuse. Such payments are likely to continue until agencies implement better systems and controls.

<u>Unreconciled Transactions</u> To make the consolidated financial statements balance, Treasury recorded a net $12 billion item on the Statement of Changes in Net Position, which it labeled unreconciled transactions. This out-of-balance amount is the net of more than $100 billion of unreconciled transactions—both positive and negative amounts—which Treasury attributes to the government's inability to properly identify and eliminate transactions between federal government entities and to agency adjustments that affected net position.

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recognition and measurement of revenue and costs. Under budgetary accounting, the budget deficit reflects outlays and receipts that generally are measured on a cash basis. For financial statement reporting purposes, costs are reported when incurred rather than when paid. Federal decisionmakers use budgetary accounting to control the use of funds and for fiscal planning. Once the federal government produces reliable consolidated financial statements, an effective reconciliation would provide additional assurance of the reliability of budget results.

MATERIAL CONTROL WEAKNESSES

While the purpose of our work was not to express, and we do not express, an opinion on internal controls, we found pervasive material weaknesses[1] in internal controls across government that contribute to these deficiencies. These weaknesses, such as the lack of effective reconciliations and poorly designed systems, result in ineffective controls over (1) safeguarding the federal government's assets from unauthorized acquisition, use, or disposition, (2) ensuring that transactions are executed in accordance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) ensuring the reliability of financial statements.

Individual agency financial statement audit reports describe the affect of such weaknesses on specific agencies and identify additional internal control weaknesses, some of which are material to individual agencies. We also found that (1) widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many material deficiencies discussed above and (2) material control weaknesses affect the government's tax collection activities. The scope of our evaluation of internal controls was limited by the deficiencies noted throughout this report.

Computer Control Weaknesses

Widespread computer control weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant information security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. In today's highly computerized and interconnected environment, such weaknesses are vulnerable to exploitation by outside intruders as well as authorized users with malicious intent.

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[1] A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that 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.

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Agencies' accounts can be out of balance with each other, for example, when one or the other of the affected agencies does not properly record a transaction with another agency or the agencies record the transactions in different time periods. These out-of-balance conditions can be detected and corrected by instituting procedures for reconciling transactions between agencies. Generally, such reconciliations are not performed. These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

Preparation of Consolidated Financial Statements The federal government cannot ensure that the information in the consolidated financial statements is consistent with agency financial statements. Treasury relies on agencies to submit data needed to prepare the federal government's consolidated financial statements. Such data consists of approximately 2,000 individual reporting components, each having many account balances. However, several agencies were unable to provide assurance that amounts submitted to Treasury agreed with their agency financial statements. In addition, many agencies needed to make significant subsequent adjustments to their submissions in an effort to properly classify amounts in the consolidated financial statements. We found further misstatements, which Treasury corrected, totalling several hundred billion dollars in agency-submitted information primarily because (1) agencies submitted incorrectly coded financial data that contributed to the unreconciled transactions described above, (2) agencies recorded similar transactions in different general ledger accounts, and (3) certain amounts were materially misallocated to net cost categories.

These problems are compounded by the substantial volume of information submitted, limitations in the federal government's current general ledger account structure, and the significant amount of other information that Treasury must gather to prepare the consolidated financial statements. As a result, additional misstatements in the government's consolidated financial statements could exist.

Cash Disbursement Activity Several major agencies are not effectively reconciling disbursements. These reconciliations are a key control—similar in concept to individuals reconciling personal checkbooks with a bank's records each month. However, there were (1) billions of dollars of unresolved gross differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1997 and (2) large amounts of unresolved differences arbitrarily written off by some agencies without adequately determining whether their records may, in fact, have been correct. As a result, the government is unable to ensure that all disbursements are properly recorded. Therefore, its financial statements could contain significant misstatements.

Reconciling the Change In Net Position with Budget Results The government did not have a process to obtain information to effectively reconcile the reported change in net position of $3 billion and the reported budget deficit of $22 billion. The reconciling items comprising the difference are typically the result of timing differences in the

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recognition and measurement of revenue and costs. Under budgetary accounting, the budget deficit reflects outlays and receipts that generally are measured on a cash basis. For financial statement reporting purposes, costs are reported when incurred rather than when paid. Federal decisionmakers use budgetary accounting to control the use of funds and for fiscal planning. Once the federal government produces reliable consolidated financial statements, an effective reconciliation would provide additional assurance of the reliability of budget results.

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Computer Control Weaknesses

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The consequences of computer control weaknesses could be devastating and costly—for instance, placing billions of dollars of payments and collections at risk of fraud and impairing military operations. In addition to these potential consequences at Treasury and Defense, identified weaknesses at agencies such as the Department of Health and Human Service's Health Care Financing Administration and the Social Security Administration place sensitive medical and other personal records at risk of disclosure.

Because computer control weaknesses are pervasive across government, in February 1997, we added information security to our list of federal high-risk areas.[2] The problem persists, in large part, because agency managers have not fully instituted a framework for assessing risk and ensuring that necessary policies and controls are in place and remain effective on an ongoing basis. Over the past 2 years, we and the IGs have issued more than 70 reports that identify computer control weaknesses in the federal government and made recommendations to address them.

Tax Collection Activities

The federal government has material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue.[3] This situation requires extensive reliance on ad hoc programming and analysis and material audit adjustments to prepare basic financial information. For example, the government currently does not obtain information necessary to identify tax collections by every type of tax at the time of collection. As a result, the government cannot separately report revenue for three of the four largest revenue sources—Social Security, Hospital Insurance, and individual income taxes. Because of this, the government had to report these three tax types in the same line item on the Consolidated Statement of Changes in Net Position. Additionally, excise tax revenues are distributed to the relevant trust funds based on assessments rather than, as required by the Internal Revenue Code, on collections.

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[2] High-Risk Series: An Overview (GAO/HR-97-1, February 1997) and High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

[3] Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

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Serious weaknesses also affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.[4] The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness, for example, has resulted in the government pursuing and collecting, from individual taxpayers, taxes that had already been paid. Additionally, the federal government is vulnerable to loss of tax revenue due to weaknesses in controls over disbursements for tax refunds. The government does not perform fundamental verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Consequently, it does not have effective controls to prevent the inappropriate payment of refunds, increasing its exposure to lost revenue.

NONCOMPLIANCE WITH LAWS AND REGULATIONS

Our objective was not to, and we do not, express an opinion on overall compliance with laws and regulations. Tests for compliance with selected provisions of laws and regulations related to financial reporting disclosed that, as discussed earlier, the federal government makes improper payments in major programs such as Medicare. Additionally, as described below, we noted material noncompliance related to financial management system requirements. However, our work would not necessarily disclose all material noncompliance. Further, the scope of our tests was limited by the inability to audit the financial statements. Other instances of noncompliance, some of which are material to individual federal agencies, are reported in the individual agency financial statement audit reports.

The Federal Financial Management Improvement Act of 1996 requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. We reported in October 1997[5] that prior audit results and agency self-reporting all point to significant challenges that agencies must meet to fully implement these requirements. The significant financial management deficiencies discussed throughout this report underscore the challenge.

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

[5] Financial Management: Implementation of the Federal Financial Management Improvement Act of 1996 (GAO/AIMD-98-1, October 1, 1997).

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The majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and cannot provide reliable financial information for managing government operations and holding managers accountable. Auditors' reports for fiscal year 1997 agency financial audits are disclosing the continuing poor shape in which agencies find their financial systems. As of the date of this report, only four agency auditors have reported that their agency's financial systems comply with the act's requirements.

YEAR 2000 COMPUTING CRISIS

The Year 2000 computing crisis is the most sweeping and urgent information technology challenge facing public and private sector organizations.[6] The federal government is extremely vulnerable due to its widespread dependence on computer systems to process financial transactions and management information, deliver vital public services, and carry out its operations. This challenge is made more difficult by the age and poor documentation of the government's existing systems and its lackluster track record in modernizing systems to deliver expected improvements and meet promised deadlines.

Consequently, we surfaced the Year 2000 computing crisis as a high-risk area across government in February 1997. Unless this issue is successfully addressed, serious consequences could occur. For example,

—payments to veterans with service-connected disabilities could be severely delayed if the system that issues them either halts or produces checks so erroneous that it must be shut down and checks processed manually;

—the Social Security Administration process to provide benefits to disabled persons could be disrupted if interfaces with state systems fail;

—federal systems used to track student loans could produce erroneous information on loan status, such as indicating that a paid loan was in default;

—Internal Revenue Service (IRS) tax systems could be unable to process returns, thereby jeopardizing revenue collection and delaying refunds; and

—the military services could find it extremely difficult to efficiently and effectively equip and sustain its forces around the world.

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[6] For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data storage and reduce operating costs. In this format, however, 2000 is indistinguishable from 1900 because both are represented as "00." As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

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In the past year, we have issued over 20 reports outlining actions underway in a wide range of federal activities to address this challenge and providing numerous recommendations for additional improvements needed. Moreover, the President recently created a Council on Year 2000 Conversion, led by an Assistant to the President, to oversee federal agencies' Year 2000 efforts, speak for the United States in national and international forums, and coordinate with governments at all levels, as well as with the private sector. While some progress has occurred, a great deal of additional effort is required to prevent serious disruptions in government operations and in financial transactions and reporting.[7] We will continue to monitor this situation and make needed recommendations.

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

When the government is able to produce them, reliable consolidated financial statements will be a valuable tool for analyzing the government's financial condition. They will also help inform budget deliberations by providing additional information beyond that provided in the budget on the long-term cost implications for a wide range of government programs. The largely cash-based budget and the financial statements offer different perspectives which, when combined, can provide a fuller view of the costs of agency programs and of the government's commitments.

A view of the long-term sustainability of fiscal policies can also be helpful to decisionmakers considering the government's financial position and making decisions about resource allocation. Such a picture requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the implied commitments of social insurance programs—such as Social Security and Medicare—must be considered in addition to those items that are quantified in the financial statements. For example, if the combined Social Security trust funds' disbursements exceed receipts, as currently estimated to occur in 2012, the government's financing needs will increase. Since 1992, in a series of long-term simulations, we have analyzed various fiscal policy alternatives and their long-term sustainability.[8]

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[7] Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-101).

[8] The most recent of these reports are Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998) and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

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FINANCIAL MANAGEMENT
IMPROVEMENTS UNDERWAY

The executive branch recognizes the extent and severity of the financial management deficiencies discussed in this report and that addressing them will require concerted improvement efforts across government. Financial management has been designated one of the President's priority management objectives, with the goal of having performance and cost information in a timely, informative, and accurate way, consistent with federal accounting standards. Also, the administration has made a commitment to complete audits and gain unqualified opinions for all CFO Act agencies and the government as a whole.

To help achieve this goal, strategies are being established involving specific agencies. For example, plans at the Department of Defense include completing a new accounting systems architecture, reviewing inventory accounting processes, and developing a departmentwide property accountability system. Treasury and OMB are developing plans to improve the accuracy and timeliness of governmentwide accounting and reporting.

OMB is also working with individual agencies to address problems precluding unqualified audit opinions, which will require the active involvement of individual agency IGs as well. We will continue to focus on financial systems and internal control deficiencies at particular agencies. For example, we have issued a series of reports[9] on the factors to be considered and the data that must be available to meet accounting standards for Defense's environmental and disposal liabilities. Also, we plan to further evaluate Defense's property and logistical systems to recommend additional corrective actions to address weaknesses in accounting for major asset categories on the financial statements. We are also working with the major credit agencies to improve reporting of loans and loan guarantees.

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[9] Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997), Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997), Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997), and Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

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

Philip T. Calder
Chief Accountant

OBJECTIVES, SCOPE, AND METHODOLOGY

The federal government is responsible for

—preparing the annual consolidated financial statements accurately and in conformity with the basis of accounting described in note 1;

—establishing, maintaining, and assessing the internal control structure to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act [10] are met, which include (1) safeguarding assets against loss from unauthorized acquisition, use, or disposition, (2) ensuring the execution of transactions in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the consolidated financial statements or that are listed in OMB's audit guidelines[11] and could have a material effect on the consolidated financial statements, and (3) recording, processing, and summarizing transactions to permit the preparation of reliable financial statements and to maintain accountability for assets; and

—complying with applicable laws and regulations.

Our objective was to audit the federal government's fiscal year 1997 consolidated financial statements.

The Government Management Reform Act (GMRA) expanded on the requirements of the CFO Act by requiring that the IGs of 24 major federal agencies annually audit agencywide financial statements prepared by these agencies.[12] Our work was performed in close coordination and cooperation with the IGs to achieve our joint audit objectives. This work included separate GAO audits of certain material agency components as discussed below. A significant portion of our work was performed at the Departments of the Treasury, Defense, and Health and Human Services, and the Social Security Administration. These agencies comprise a major portion of the amounts reported in the federal government's consolidated financial statements. At other federal agencies, we focused largely on accounts that are material to the consolidated financial statements. We

[10] The Federal Managers' Financial Integrity Act requires agency managers to evaluate and report annually to the President and the Congress on the adequacy of their internal controls and accounting systems and what is being done to correct the problems.

[11] OMB Bulletin 93-06, Audit Requirements for Federal Financial Statements, January 8, 1993.

[12] GMRA authorized OMB to designate agency components that also would receive a financial statement audit.

performed sufficient audit work to provide our report on the consolidated financial statements, internal controls, and compliance with laws and regulations.

We separately audited the following material agency components

—We audited and expressed an unqualified opinion on the IRS custodial financial statements for fiscal year 1997. These financial statements reported over $1.6 trillion of tax revenue, $142 billion of tax refunds, and $28 billion of net federal taxes receivable.[13]

—We audited and expressed an unqualified opinion on the Schedule of Federal Debt Managed by Treasury's Bureau of the Public Debt.[14] This schedule reported (1) $3.8 trillion of federal debt held by the public comprising individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks, (2) $1.6 trillion of federal debt held by federal entities, such as the Social Security trust funds, and (3) $246 billion of interest on federal debt held by the public.

—We performed audit procedures on cash balances maintained and internal controls over the cash receipts and disbursements processed by Treasury on behalf of the federal government.

We provided the results of our work at Treasury to the Treasury Office of Inspector General for consideration in its audit of Treasury's fiscal year 1997 departmentwide financial statements.

—We audited and expressed unqualified opinions on the December 31, 1997, financial statements of the Bank Insurance Fund and on the December 31, 1996, financial statements for all of the funds administered by the Federal Deposit Insurance Corporation (FDIC).[15] We also performed additional audit procedures on FDIC's balances at September 30, 1997.

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[13] Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

[14] Financial Audit: Examination of the Bureau of the Public Debt's Fiscal Year 1997 Schedule of Federal Debt (GAO/AIMD-98-65, February 27, 1998).

[15] Financial Audit: Bank Insurance Fund's 1997 Financial Statements (B-279515, March 25, 1998) and Financial Audit: Federal Deposit Insurance Corporation's 1996 and 1995 Financial Statements (GAO/AIMD-97-111, June 30, 1997).

We also made significant preparations for the fiscal year 1997 audit work, including the following.

—At the Department of the Treasury, we conducted audits of IRS's financial statements since fiscal year 1992 and conducted the initial financial statement audits of the U.S. Customs Service.

—At the Department of Health and Human Services, we worked closely with the IG in testing Medicare and Medicaid expenditures for fiscal year 1996, which resulted in the IG reporting an estimated $23 billion of improper Medicare fee-for-service payments.

—At the Department of Defense, we conducted initial financial audits at the military services over a period of several years. Also, leading up to the fiscal year 1997 audit, we assessed progress in resolving weaknesses, including those related to disbursements, inventories, and property and equipment.

—At the Social Security Administration, we focused our efforts on key areas such as benefit expenditures, computer controls, and actuarial projections.

—At these and other agencies, we reviewed the fiscal year 1996 financial statement audits performed by the IGs or their contractors and, for certain agencies, assisted in the development of audit plans for fiscal year 1997 audits.

Agency-level financial statements and audit reports for the agencies covered by the CFO Act provide additional information about the operations of each of these entities. For example, these audits have identified numerous internal control and accounting systems weaknesses and noncompliance, many of which are material to the respective agencies or components. Further, as of the completion of our field work, several agencies received unqualified opinions on fiscal year 1997 financial statements. These agencies are the:

—Social Security Administration.
—National Aeronautics and Space Administration.
—Nuclear Regulatory Commission.
—Department of Energy.
—General Services Administration.
—Department of Labor.
—Small Business Administration.
—Environmental Protection Agency.

United States Government Consolidated Financial Statements for the year ended September 30, 1997

Balance sheet

This statement shows the operating assets of the Government that were acquired under fiscal 1997, and prior year budgets; and which remain available as resources to supply Government goods and services in the future. It also shows the Government's operating liabilities including debt held by the public. It includes some liabilities that have not yet been funded by appropriations. The net position shown in the statement reflects operating assets less liabilities.

The balance sheet does not include values for certain assets or future responsibilities under social insurance programs such as Social Security and Medicare. Excluded assets include land not used in general operations, natural resources and assets held solely for their historical, cultural or artistic significance. The balance sheet also does not reflect the Government's power to tax. Deferred maintenance is not shown this year but will be disclosed in future years after agencies implement the new accounting standard requiring such information.

The stewardship reporting section provides information on the Government's future responsibilities for social insurance and on the Government's land not used in general operations. An explanation of the nature of the social insurance trust funds is included in Note 16 together with information about the receipts, disbursements and assets of the major social insurance trust funds. The stewardship reporting section will be expanded in future years to disclose additional information required by recently approved accounting standards.

The line item "commitments and contingencies" is displayed to inform the reader that a note disclosure is presented, relating to certain existing conditions, situations or sets of circumstances involving uncertainty as to possible gain or loss. The amounts stated there are in terms of maximum theoretical risk exposure. However, it is not likely that the maximum loss will be incurred.

United States Government
Consolidated Balance Sheet
as of September 30, 1997

(In billions of dollars)

Assets:	
Cash and other monetary assets (Note 2)	92.7
Accounts receivable	35.2
Loans receivable (Note 3)	156.2
Taxes receivable (Note 4)	28.1
Inventories and related property (Note 5)	209.4
Property, plant and equipment (Note 6)	1,017.0
Other assets (Note 7)	62.9
Total assets	1,601.5
Liabilities and net position:	
Accounts payable (Note 8)	97.7
Federal debt securities held by the public (Note 9)	3,768.2
Federal employee and veteran benefits payable (Note 10)	2,243.7
Environmental liabilities (Note 11)	211.7
Benefits due and payable (Note 12)	77.7
Loan guarantee liabilities (Note 3)	36.7
Other liabilities (Note 13)	168.8
Total liabilities	6,604.5
Commitments and contingencies (Note 14)	
Net position	-5,003.0
Total liabilities and net position	1,601.5

The accompanying notes are an integral part of these financial statements.

Statement of net cost

This statement shows the net cost of Government operations for fiscal 1997, which is funded by taxation or through Federal borrowing. The statement reflects the cost incurred to carry out the national priorities as determined by law.

Cost is divided among major functions, which are the same as in the budget except that the allocation of cost to the functions is based on accounting standards. Thus, cost are reported on an accrual basis and allocated differently than in the budget. For example, the cost of pensions and retiree health benefits are allocated among all the functions that employ workers rather than as a subfunction in the income security function. A description of each of the functions and the component of net cost for the activities included in such function is located immediately following the statement.

The statement contains the following three components for each function: The gross cost of Government operations; the revenues earned from the public for goods and services; and the net cost of Government operations, which is the gross cost less the revenue earned.

Gross cost

Gross cost includes the full cost of the functions. These costs may be directly traced, assigned on a cause and effect basis or reasonably allocated to the function.

Earned revenue

These are revenues that the U.S. Government has earned by providing goods and services to the public at a price.

Net cost

The net cost of Government operations is the gross cost less the related revenues.

United States Government
Consolidated Statement of Net Cost
for the year ended September 30, 1997

(In billions of dollars)	Gross cost	Earned revenue	Net cost
National defense	251.9	18.4	233.5
Human resources:			
Education, training, employment and social services	46.6	2.2	44.4
Health	125.5	1.2	124.3
Medicare	207.7	20.5	187.2
Income security	187.9	8.8	179.1
Social Security	364.1	-	364.1
Veterans benefits and services	36.1	2.2	33.9
Total human resources	967.9	34.9	933.0
Physical resources:			
Energy	18.0	12.8	5.2
National resources and environment	29.1	1.9	27.2
Commerce and housing credit	86.7	72.4	14.3
Transportation	37.4	2.4	35.0
Community and regional development	12.2	1.9	10.3
Total physical resources	183.4	91.4	92.0
Net interest:			
Treasury securities held by the public	246.1	-	246.1
Other functions:			
International affairs	24.8	5.3	19.5
General science, space and technology	16.8	0.1	16.7
Agriculture	15.1	2.5	12.6
Administration of justice	27.1	1.9	25.2
General government	28.0	3.3	24.7
Total other functions	111.8	13.1	98.7
Total	1,761.1	157.8	1,603.3

The accompanying notes are an integral part of these financial statements.

Net cost functional classification

The statement of net cost presents information about the cost of the Government's major functions. The objectives of each of the functions are described below.

National defense

The cost of national defense includes the costs for providing military forces to (1) deter war; (2) be prepared to engage in war; and (3) preserve the peace and security of the United States, the Territories, Commonwealth, its possessions and any area occupied by the United States. Such costs also include training, equipping and compensating the armed forces; developing, acquiring, utilizing and disposing of weapon systems; conducting research and development to maintain technological superiority over potential adversaries, and improving cost and performance of weapon systems; and other defense related activities.

Changes to fiscal 1996 estimates

(In billions of dollars)

Environmental management and legacy wastes	43.3
Pipeline facilities	2.7
Active facilities	1.4
High-level waste and spent nuclear fuel	-0.1
Other changes in estimates	0.4
Total changes in estimates	47.7

National defense includes changes in estimated environmental liabilities. The revised estimates resulted in a net decrease of $47.7 billion in environmental liabilities during fiscal 1997. The accompanying table depicts the changes in estimate by category.

Human resources

Education, training, employment and social services

The objectives of the education, training, employment and social services function are to promote the extension of knowledge and skills, enhance employment and employment opportunities, protect workplace standards and provide services to the needy.

Health

The cost of health is for promoting physical and mental health, including the prevention of illness and accidents, and the Medicaid program. The Medicare program is the largest Federal health program, but by law it is in a separate subfunction for budget purposes. Also excluded from the health subfunction is Federal health care for military personnel and veterans.

Medicare

Medicare is composed of Federal hospital insurance and Federal supplementary medical insurance. This function is not further subdivided into subfunctions. For more information on Medicare, see the note on stewardship

Education, training, employment and social services

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Elementary, secondary and vocational education	14.5	-	14.5
Higher education	7.1	2.2	4.9
Research and general education aids	1.9	-	1.9
Training and employment	4.9	-	4.9
Other labor services	0.9	-	0.9
Social services	16.3	-	16.3
Cost not allocated to subfunctions	1.0	-	1.0
Total education, training, employment and social services	46.6	2.2	44.4

Health

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Health care services	120.8	4.5	116.3
Health research and training	2.6	0.7	1.9
Consumer and occupational health and safety	2.0	0.1	1.9
Cost not allocated to subfunctions	0.1	-4.1	4.2
Total health	125.5	1.2	124.3

Income security

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Unemployment compensation	24.4	1.2	23.2
Housing assistance	27.4	-	27.4
Food and nutritional assistance	36.4	-	36.4
General retirement and disability insurance	15.5	3.5	12.0
Other income security	73.2	2.9	70.3
Cost not allocated to subfunctions	11.0	1.2	9.8
Total income security	187.9	8.8	179.1

Veterans benefits and services

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Income security for veterans	8.3	0.9	7.4
Veterans education, training and rehabilitation	1.8	-	1.8
Hospital and medical care for veterans	16.3	0.5	15.8
Veterans housing	0.5	0.6	-0.1
Other veterans benefits and services	1.6	0.2	1.4
Cost not allocated to subfunctions	7.6	-	7.6
Total veterans benefits and services	36.1	2.2	33.9

responsibility in the stewardship reporting section and Note 16.

Income security

This includes the cost of providing payments to persons for whom no current service is rendered. Included are disability, unemployment, welfare and similar programs, except for Social Security and income security for veterans. Also included are (1) the food stamp, special milk and child nutrition programs; (2) unemployment compensation and workers' compensation; (3)public assistance cash payments; (4) benefits to the elderly and to coal miners; and (5) low- and moderate-income housing benefits. The cost of Federal pensions and retiree health benefits are allocated to other functions.

Social Security

The cost of Social Security is for payments to eligible beneficiaries of the Old Age and Survivors Insurance and Disability Insurance programs, which are collectively referred to as "Social Security." The Social Security program is the single largest Federal program and is funded primarily by payroll taxes.

For more information on Social Security, see the note on stewardship responsibility in the stewardship reporting section and Note 16.

Veterans benefits and services

These programs provide benefits and services, the eligibility for which is related to prior military service. Included are veteran's compensation, life insurance, pensions, burial benefits, education, training, medical care, veterans housing and administrative expenses of the Department of Veterans Affairs.

Physical resources

Energy

The objective is to promote an adequate supply and appropriate use of energy to serve the needs of the economy.

Natural resources and environment

These costs are incurred for developing, managing and maintaining the nation's natural resources and environment. Excluded are the cost for community water supply programs, basic sewer systems and waste treatment plants, all of which are part of community or regional development programs.

Commerce and housing credit

These costs relate to the promotion and regulation of commerce, housing, and deposit insurance industries, which pertain to (1) collection and dissemination of social and economic data; (2) general purpose subsidies to business and individuals including credit subsidies to housing; and (3) the Postal Service fund.

Transportation

Most of these costs relate to grants to States and others for local or national transportation of passengers and property. These costs include: (1) construction of facilities; (2) purchase of equipment; (3) research, testing and evaluation; and (4) operating subsidies for transportation facilities (such as airports and railroads).

Energy

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Energy supply	15.4	11.8	3.6
Energy conservation	0.5	-	0.5
Emergency energy preparedness	0.2	0.3	-0.1
Energy information, policy and regulation	0.7	-	0.7
Cost not allocated to subfunctions	1.2	0.7	0.5
Total energy	18.0	12.8	5.2

Natural resources and environment

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Water resources	6.8	0.1	6.7
Conservation and land management	6.1	0.9	5.2
Recreational resources	2.6	0.2	2.4
Pollution control and abatement	6.8	0.3	6.5
Other natural resources	2.5	0.2	2.3
Cost not allocated to subfunctions	4.3	0.2	4.1
Total natural resources and environment	29.1	1.9	27.2

Commerce and housing credit

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Mortgage credit	3.0	5.5	-2.5
U.S. Postal Service	56.9	58.4	-1.5
Deposit insurance	-2.5	5.9	-8.4
Other advancement of commerce	5.5	14.1	-8.6
Cost not allocated to subfunctions	23.8	-11.5	35.3
Total commerce and housing credit	86.7	72.4	14.3

Transportation

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Ground transportation	24.6	1.7	22.9
Air transportation	6.6	0.1	6.5
Water transportation	-0.5	0.6	-1.1
Other transportation	0.2	-	0.2
Cost not allocated to subfunctions	6.5	-	6.5
Total transportation	37.4	2.4	35.0

Community and regional development

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Community development	4.9	-	4.9
Area and regional development	2.1	0.5	1.6
Disaster relief and insurance	4.6	1.4	3.2
Cost not allocated to subfunctions	0.6	-	0.6
Total community and regional development	12.2	1.9	10.3

Community and regional development

These costs relate to the development of physical facilities or financial infrastructures designed to promote viable community economies. Transportation facilities developed as integral parts of community development programs are also included. Aid to businesses is not usually included in this function unless such aid promotes the economic development of depressed areas and is not designed to promote particular lines of business for their own sake.

Net interest

Interest costs are primarily the amounts accrued on Treasury securities held by the public. Interest payments on these securities are made by the Treasury's Bureau of Public Debt.

Other functions

International affairs

This function includes the cost of maintaining peaceful relations, commerce and travel between the United States and the rest of the world, and promoting international security and economic development abroad.

General science, space and technology

This function includes the research conducted by the National Science Foundation, all space programs conducted by the National Aeronautics and Space Administration (NASA) and general science research supported by the Department of Energy.

Agriculture

These costs are for promoting the economic stability of agriculture and the nation's capability to maintain and increase agricultural production.

Administration of justice

These costs include programs to provide judicial services, police protection, law enforcement (including civil rights), rehabilitation and incarceration of criminals, and the general maintenance of domestic order. It includes the provision of court-appointed counsel or other legal services for individuals. It excludes the cost of the legislative branch and police or guard activities to protect Federal property. The cost of National Guard personnel and military personnel who are called upon occasionally to maintain public safety and the cost of military police are included un-

International affairs

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
International development and humanitarian assistance	10.7	3.1	7.6
International security assistance	2.2	-	2.2
Conduct of foreign affairs	5.1	0.3	4.8
Foreign information and exchange activities	-	-	-
International financial programs	3.8	1.2	2.6
Cost not allocated to subfunctions	3.0	0.7	2.3
Total international affairs	24.8	5.3	19.5

General science, space and technology

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
General science and basic research	3.8	-	3.8
Space flight, research and supporting activities	12.3	0.1	12.2
Cost not allocated to subfunctions	0.7	-	0.7
Total general science, space and technology	16.8	0.1	16.7

Agriculture

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Farm income stabilization	10.6	2.2	8.4
Agricultural research and service	3.5	0.3	3.2
Cost not allocated to subfunctions	1.0	-	1.0
Total agriculture	15.1	2.5	12.6

der the national defense function rather than this function.

General government

These costs include the general overhead of the Federal Government, including legislative and executive activities, and provision of central fiscal, personnel and property activities. All activities reasonably or closely associated with other functions are included in those functions rather than general government.

Administration of justice

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Federal law enforcement activities	13.2	1.1	12.1
Federal litigative and judicial activities	5.9	-	5.9
Federal correctional activities	3.3	0.3	3.0
Criminal justice assistance	1.3	0.4	0.9
Cost not allocated to subfunctions	3.4	0.1	3.3
Total administration of justice	27.1	1.9	25.2

General government

(In billions of dollars)

Subfunctions	Gross cost	Earned revenue	Net cost
Legislative functions	1.2	-	1.2
Executive direction and management	0.3	-	0.3
Central fiscal operations	8.3	2.2	6.1
General property and records management	10.1	0.3	9.8
Central personnel management	0.2	-	0.2
General purpose fiscal assistance	0.3	-	0.3
Other general government	0.9	0.1	0.8
Cost not allocated to subfunctions	6.7	0.7	6.0
Total general government	28.0	3.3	24.7

Statement of changes in net position

The statement of changes in net position reports the beginning net position, the items that caused net position to change during the reporting period and the ending net position. It shows the net cost of Government operations, revenues generated principally by the Government's sovereign power to tax, levy duties, and assess fines and penalties, as well as any adjustments and unreconciled transactions that affect the net position.

Net cost of Government operations

Net cost of Government operations is the cost of operations reported in the statement of net cost.

Revenues: financing sources from non-exchange revenue

The main financing source for the net cost of operations is non-exchange revenue, which consists of taxes and other revenue that the Federal Government generates under its governmental powers or receives by donation.

Other earned revenue

Other earned revenues are exchange revenues from the public with virtually no cost associated with these earnings. These items include revenues from spectrum auctions and rents and royalties on the outer continental shelf lands.

Unreconciled transactions

Unreconciled transactions are adjustments made to balance the change in net position.

Net position–beginning of period

The amount is the net position reported as of the beginning of the fiscal year.

Net position–end of period

This is the amount reported as net position on the current year's balance sheet.

United States Government
Consolidated Statement of Changes in Net Position
for the year ended September 30, 1997

(In billions of dollars)

Net cost of Government operations. . . .		1,603.3		
Less:				
Financing sources from non-exchange revenues:				
Individual income tax and tax withholdings	1,247.5			
Corporation income taxes	179.8			
Unemployment taxes	27.8			
Excise taxes	55.8			
Estate and gift taxes	19.7			
Customs duties	20.0			
Miscellaneous	26.1			
Total non-exchange revenues.		1,576.7		
Other earned revenues		11.6		
Excess of costs over revenues before unreconciled transactions			-15.0	
Unreconciled transactions affecting the change in net position (Note 15) .			12.4	
Change in net position				-2.6
Net position-beginning of period				-5,000.4
Net position-end of period				-5,003.0

The accompanying notes are an integral part of these financial statements.

United States Government Notes to the Financial Statements for the year ended September 30

Note 1. Summary of significant accounting policies

A. Reporting entity

The consolidated financial statements include the financial status and activity of the executive, legislative and judicial branches of the U.S. Government, including those Government corporations that are part of the Federal Government. The Appendix contains a list of significant U.S. Government entities included and entities excluded from these consolidated financial statements. For the purposes of this document, "Federal Government" refers to the U.S. Government. The fiscal year of the U.S. Government ends September 30. Material intragovernmental transactions have been eliminated in consolidation, except as described in Note 15.

B. Basis of accounting

The consolidated financial statements have been prepared in accordance with Form and Content guidance specified by the Office of Management and Budget (OMB) and the Statements of Federal Financial Accounting Standards (SFFAS). Under this basis of accounting, expenses generally are recognized when incurred and non-exchange revenues are recognized on a modified cash basis of accounting. Remittances of non-exchange revenues are recognized when received and related receivables are recognized when measurable and legally collectible. Refunds and related offsets of non-exchange revenues are recognized when measurable and legally payable. Exchange revenues are recognized when earned. This basis of accounting differs from the basis of accounting used for budgetary reporting. Beginning in fiscal 1998, four additional accounting standards will be effective regarding accounting for property, plant and equipment, managerial cost accounting, revenue and other financing sources, and supplementary stewardship reporting. The impact of these standards on the consolidated financial statements is currently being reviewed.

C. Direct loans and loan guarantees

Direct loans obligated and loan guarantees committed after September 30, 1991, are recorded based on the present value of net cash flows estimated over the life of the loan or guarantee. Direct loans made prior to October 1, 1991, may be recorded under the present value method or the allowance for loss method (the outstanding principal reduced by an allowance for uncollectible amounts when it is more likely than not that the loans will not be collected in full). Liabilities related to loan guarantees committed prior to October 1, 1991, may be recorded under the present value method or the allowance for loss method (the amount the agency estimates will more likely than not require a future cash outflow to pay default claims).

D. Taxes receivable

"Taxes receivable" primarily consist of uncollected tax assessments, penalties and interest, where taxpayers have agreed that the amounts are owed or a court has determined that the assessments are owed. Unpaid assessments where (1) neither taxpayers nor a court have agreed that the amounts are owed (compliance assessments); and (2) the Government does not expect further collections due to factors such as the taxpayer's death, bankruptcy or insolvency (write-offs) are not included in the financial statements. Taxes receivable are reported net of an allowance for the estimated portion of the taxes receivable deemed to be uncollectible.

E. Inventories and related property

Inventories generally are valued at historical cost or at an approximation thereof. Historical cost methods include first-in-first-out, weighted average and moving average. The value of inventory held for repair is reduced by the estimated repair cost. Excess, obsolete and unserviceable inventories are valued at estimated net realizable values.

F. Property, plant and equipment

"Property, plant and equipment" (PP&E) are recorded using purchase price, replacement cost, standard cost and other acceptable methods. Defense weapons systems, which comprise most of the PP&E, are not currently depreciated. Depreciation and amortization expense, which applies to other PP&E, except land and limited duration land rights and construction in progress, are generally recognized using the straight-line method over the assets estimated useful lives. The Government Management Reform Act does not require the legislative and judicial branches to report their financial information to Treasury, therefore most PP&E in use by those entities is not included in these consolidated financial statements.

G. Retirement programs

"Pension expense and retirement health benefits" and related liabilities are recorded during the time that employee services are rendered. The liabilities for defined benefit pension plans and retirement health benefits are recorded at estimated actuarial present value of future benefits, less the estimated actuarial present value of normal cost contributions made by, and for covered employees.

"Normal cost" is the portion of the actuarial present value of projected benefits allocated, under the actuarial method, as expense for employee services rendered in the current year. Actuarial gains and losses (and prior and past service cost, if any) are recognized immediately in the year they occur, without amortization.

H. Environmental liabilities

"Environmental liabilities" are recorded at the estimated current cost to remediate hazardous waste and environmental contamination, assuming the use of current technology. Remediation consists of removal, treatment and/or safe containment. Where technology does not exist to clean up hazardous waste, only the estimable portion of the liability, typically safe containment, is recorded.

I. Contingencies

Liabilities are recognized on the balance sheet when:

- a past transaction or event has occurred; and
- a future outflow or other sacrifice of resources is probable and measurable.

The estimated contingent liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized.

Contingent liabilities that do not meet the above criteria for recognition, but for which there is a reasonable possibility that a loss has been incurred are disclosed in Note 14.

For the fiscal year ended September 30, 1997, the amount of loss contingencies was not available therefore, the amounts stated here represent the maximum theoretical risk exposure. However, it is not likely that the maximum loss will be incurred.

J. Social insurance

A liability for social insurance programs (Social Security, Medicare, Unemployment Insurance, Railroad Retirement and Black Lung) is recognized for any unpaid amounts due as of the reporting date. No liability is recognized for future payments not yet due. See "stewardship responsibilities" in the stewardship reporting section for further information.

K. Related party transactions

The Federal Reserve Banks (FRBs), which are not part of the reporting entity, serve as the Federal Government's depositary and fiscal agent. They process Federal payments and deposits to Treasury's account and service Federal debt securities. FRBs owned $440 billion of Federal debt securities held by the public as of September 30, 1997. FRB earnings that exceed statutory amounts of surplus established for the Federal banks are paid to the Federal

Government and are recognized as non-exchange revenue and totaled $19.6 billion for the year ended September 30, 1997. The primary source of these earnings is from interest earned on Federal debt securities held by the FRBs.

FRBs issue Federal Reserve Notes, which are the circulating currency of the United States. These notes are collateralized by specific assets owned by the FRBs, typically U.S. Government securities. Federal Reserve Notes are backed by the full faith and credit of the United States Government.

The Federal Government does not guarantee payment of the liabilities of Government-sponsored enterprises such as the Federal National Mortgage Association of the Federal Home Loan Mortgage Association, which also are excluded from the reporting entity.

Note 2. Cash and other monetary assets

Cash and other monetary assets as of September 30

(In billions of dollars)

Cash before outstanding checks	49.6	
Outstanding checks	-3.9	
Cash		45.7
Gold		11.0
Domestic monetary assets		0.4
International monetary assets		35.6
Total cash and other monetary assets		92.7

Cash

Cash in the amount of $45.7 billion, consists of: (1) U.S. Treasury balances held at the Federal Reserve banks, net of outstanding checks; (2) U.S. Treasury balances in special depositaries that hold the proceeds of certain tax payments known as the U.S. Treasury Tax and Loan Note accounts; (3) funds held outside of Treasury and the Federal Reserve by authorized fiscal officers or agents; (4) monies held by Government collecting and disbursing officers, agencies' undeposited collections, unconfirmed deposits and cash transfers; and (5) time deposits at financial institutions.

The U.S. Government maintains formal arrangements with numerous banks to maintain time deposits known as compensating balances. These balances compensate the banks for services provided to the Federal Government, such as maintaining zero-balance accounts for the collection of public monies.

Gold

Gold is valued at the statutory price of $42.2222 per fine troy ounce. As of September 30, 1997, the number of fine troy ounces was 260,914,524.931. In the fiscal year ended September 30, 1996, gold was valued using market value, which represented the price reported for gold on the London Fixing. The market value of gold as of the reporting date is $332.10 per fine troy ounce. Gold has been pledged as collateral for gold certificates issued to the Federal Reserve banks totaling $11.0 billion (see Note 13).

Domestic monetary assets

"Domestic monetary assets" are composed of liquid assets other than cash that are based on the U.S. dollar including coins, silver bullion and other coinage metals. These items totaled $0.4 billion.

International monetary assets

"International monetary assets" are composed of liquid assets that are denominated on a basis other than the U.S. dollar. Special Drawing Rights (SDRs) are international reserve assets created by the International Monetary Fund (IMF), which have a U.S. dollar equivalent of $10.0 billion calculated on a weighted average of exchange rates for the currencies of selected IMF member countries. The value of a SDR was $1.36521, as of September 30, 1997. SDRs have been pledged as collateral for borrowing from the Federal Reserve banks. This liability totals $9.2 billion and is included in Note 13. These assets also include the U.S. reserve position in the IMF, which has a U.S. dollar equivalent of $14.0 billion, and foreign currency and other monetary assets denominated in foreign currency. International monetary assets have a U.S. dollar equivalent of $35.6 billion.

Note 3. Loans receivable and loan guarantee liabilities

Loans receivable

The Federal Government is the nation's largest source of credit and underwriter of risk. In 1990, the Federal Credit Reform Act was enacted to improve the Government's budgeting and management of credit programs. The primary focus of the Act is to provide an accurate measure of the long-term costs of both direct loans and loan guarantees and to recognize these costs at the time when the loan is made.

The Direct Student Loan program, established in 1994, offers four types of education loans: Stafford, Unsubsidized Stafford, PLUS for parents and Consolidation. Evidence of financial need is required for a students to receive subsidized Stafford loans. The other three loan programs are available to borrowers at all income levels. These loans usually mature 9-13 years after the student is no longer enrolled and are unsecured.

Rural electrification and telecommunications loans are for the construction and operation of generating plants, electric transmission, and distribution lines or systems. These loans carry an average maturity of greater than 20 years and are usually secured.

The major programs funded through the Rural Housing Insurance Fund Program account are: very low and low-to-moderate income home ownership loans and guarantees, very low income housing repair loans, domestic farm labor housing loans, housing site loans and credit sales of acquired property. Loan programs are limited to rural areas that include towns, villages and other places that are not part of an urban area. The majority of these loans mature in excess of 25 years and are secured by the property of the borrower.

Economic assistance loans provide economic assistance to selected countries in support of U.S. efforts to promote stability and U.S. security interests in strategic regions of the world.

Loan guarantees

The Federal Housing Administration (FHA) provides mortgage insurance to encourage lenders to make credit available to expand home ownership. FHA predominately serves borrowers that the conventional market does not adequately serve: first time home buyers, minorities, lower-income families and residents of under-served areas.

The Federal Family Education Loan (FFEL) program, formerly known as the Guaranteed Student Loan program, was established in 1965. Like the Direct Student Loan program, it also offers

Loans receivable as of September 30

(In billions of dollars)	Gross receivables [1]	Allowance losses (pre-1992)	Allowance for subsidy (post-1991)	Net receivables
Student loan programs	42.0	14.6	0.1	27.3
Rural electrification and telecommunications	28.3	4.8	-	23.5
Rural housing insurance	20.9	7.4	-	13.5
Economic assistance loans	12.5	5.1	-	7.4
Agriculture credit insurance fund	10.7	1.5	0.6	8.6
Other loans receivable	102.2	18.0	8.3	75.9
Total loans receivable	216.6	51.4	9.0	156.2

[1] Includes related interest

Loan guarantees as of September 30

(In billions of dollars)

	Face value of guaranteed loans	Amount guaranteed	Loan guarantee liability
Federal Housing Administration	454.5	447.0	13.1
Federal Family Education	99.0	99.0	9.9
Veteran housing benefits...........	198.0	69.4	4.1
All other loan guarantees	125.3	97.0	9.6
Total loan guarantees	876.8	712.4	36.7

four types of loans: Stafford, Unsubsidized Stafford, PLUS for parents and Consolidation.

Veteran housing benefits provide partial guarantee of residential mortgage loans issued to eligible veterans and servicemen by private lenders. The guarantee allows veterans and servicemen to purchase a home without a substantial down payment.

Other loan guarantees include Small Business Administration loans to minority businesses, Export-Import Bank loans to promote U.S. exports, and the Farm Service Agency for farm ownership and emergency and disaster loans.

Note 4. Taxes receivable

Taxes receivable as of September 30

(In billions of dollars)

Gross Federal tax receivables.........	90.2
Allowance for doubtful amounts....	62.1
Federal tax receivables, net	28.1

"Net taxes receivable" are based on projections of collectibility from a statistical sample.

Note 5. Inventories and related property

Inventories and related property as of September 30

(In billions of dollars)

Operating materials and supplies............	161.8
Stockpile materials........	41.8
Inventory held for sale.....	1.7
Foreclosed property	1.3
Commodities	0.4
Seized monetary instruments	0.2
Forfeited property	0.2
Other related property....	2.0
Total inventories and related property...	209.4

"Inventories and related properties" consist of the following categories, net of allowance:

- "Operating materials and supplies," which are comprised of tangible personal property purchased for use in normal operations.
- "Stockpile materials," which are strategic and critical materials held due to statutory requirements for use in national defense, conservation or national emergencies.
- "Inventory held for sale," which is tangible personal property held for sale net of allowances.

- "Foreclosed property," which includes assets received in satisfaction of a loan receivable or as a result of payment of a claim under a guaranteed or insured loan (excluding commodities acquired under price support programs).
- "Commodities," which are items of commerce or trade having an exchange value used to stabilize or support market prices.
- "Seized monetary instruments," which include only monetary instruments. Other seized property, including real property and tangible personal property, are accounted for in agency property management records until the property is forfeited, returned or otherwise liquidated.
- "Forfeited property," which is comprised of (1) monetary instruments, intangible property, real property and tangible personal property acquired through forfeiture proceedings; (2) property acquired by the Government to satisfy a tax liability; and (3) unclaimed and abandoned merchandise.
- "Other related property," which includes all other related property not included above (such as property acquired through military base closings).

Note 6. Property, plant and equipment

Certain types of fixed assets are not reported as "property, plant and equipment" or elsewhere on the balance sheet. These include natural resources, stewardship land, monuments, museum collections and library collections. FASAB standards are addressing the issue of these unreported assets. Future consolidated financial statements may report them as supplementary stewardship information. Land not used in connection with the production of goods and services is disclosed in the stewardship reporting section under stewardship land. In future financial statements, values will be removed from the balance sheet for national defense "property, plant and equipment" and the stewardship reporting section of the financial statements will be expanded to include information about these assets.

Note 7. Other assets

Other assets as of September 30

(In billions of dollars)

Advances and prepayments	24.2
Securities and investments	11.4
Other	27.3
Total other assets	62.9

Property, plant and equipment as of September 30

(In billions of dollars)	Cost or other basis	Accumulated depreciation/ amortization	Net
Buildings, structures and facilities	281.5	64.2	217.3
Military equipment	637.1	1.6	635.5
Furniture, fixtures and equipment	110.7	33.7	77.0
Assets under capital lease	6.6	0.3	6.3
Leasehold improvements	1.4	0.4	1.0
Automated data processing software	2.0	1.0	1.0
Land	22.4	-	22.4
Construction in progress	56.5	-	56.5
Total property, plant and equipment	1,118.2	101.2	1,017.0

"Other assets" consist of advances and prepayments, securities and investments and other assets of the U.S. Government not otherwise classified. Securities are shown at cost net of unamortized premiums and discounts.

Note 8. Accounts payable

"Accounts payable" are amounts owed for accrued interest on the public debt, goods and other property ordered and received, and for services rendered by other than employees.

Note 9. Federal debt securities held by the public

Definitions of debt are as follows:

- "Gross Federal debt" includes Federal Government debt, whether issued by Treasury (public debt) or by other agencies (agency debt). Gross

Accounts payable as of September 30

(In billions of dollars)

Department of the Treasury	46.6
Department of Defense	17.4
U.S. Postal Service	4.8
Department of Veterans Affairs	3.1
National Aeronautics and Space Administration	3.0
Office of Personnel Management	2.8
Department of Agriculture	2.5
Department of Health and Human Services	2.5
All other departments	15.0
Total accounts payable	97.7

Federal debt securities held by the public as of September 30

(In billions of dollars)		Average interest rate
Treasury securities:		
Marketable securities	3,439.8	6.668%
Non-marketable securities	1,967.7	7.235%
Non-interest bearing debt	5.6	
Total Treasury securities	5,413.1	
Plus: Unamortized premium on Treasury securities	20.2	
Less: Unamortized discount on Treasury' securities	78.2	
Total Treasury securities, net of unamortized premiums and discounts	5,355.1	
Agency securities:		
Tennessee Valley Authority	27.4	
U.S. Postal Service	3.9	
All other agencies	1.9	
Less: Unamortized net discounts	0.5	
Total agency securities	32.7	
Total Federal debt	5,387.8	
Less: Intragovernmental holdings, net of unamortized premiums and discounts	1,619.6	
Total Federal debt securities held by the public	3,768.2	

Types of marketable securities

Bills: Short-term obligations issued with a term of 1 year or less.
Notes: Medium-term obligations issued with a term of at least 1 year, but not more than 10 years.
Bonds: Long-term obligations of more than 10 years.

Intragovernmental holdings: Federal debt securities held as investment by Government accounts as of September 30

(In billions of dollars)

Holdings over $100 billion:	
Social Security Administration, Old Age and Survivors Insurance	567.5
Office of Personnel Management, Civil Service Retirement and Disability	422.1
Department of Defense, Military Retirement	126.0
Department of Health and Human Services, Hospital Insurance Fund	116.6
Subtotal	1,232.2
Holdings over $15 billion:	
Social Security Administration, Disability Insurance Trust Fund	63.6
Department of Labor, Unemployment	61.9
Federal Deposit Insurance Corporation funds	37.4
Department of Health and Human Services, Supplemental Medical Insurance	34.5
Department of Transportation, Highway Trust Fund	22.3
Railroad Retirement Board	19.2
Office of Personnel Management, Employees Life Insurance	18.0
Department of the Treasury, Exchange Stabilization Fund	15.5
Subtotal	272.4
Other programs and funds	102.8
Subtotal	1,607.4
Plus: Unamortized net premiums	12.2
Total intragovernmental holdings	1,619.6

Federal debt is either held by the public or by U.S. Government entities.

- "Debt held by the public" includes Federal debt held outside the U.S. Government by individuals, corporations, State or local governments, the Federal Reserve System, and foreign governments and central banks.
- "Intragovernmental holdings" are comprised of Federal debt held by Government trust funds, revolving funds and special funds.

"Federal debt held by the public" amounted to $3,768.2 billion at the end of fiscal 1997. The table on debt held by the public reflects information on borrowing to finance Government operations. Debt is shown at face value with unamortized premiums added and unamortized discounts subtracted.

Intragovernmental holdings represent that portion of the total Federal debt securities held as investments by Federal entities, including major trust funds. For more information on trust funds see Note 16. Intragovernmental holdings have been eliminated in consolidation for financial statement presentation purposes.

Securities that represent debt held by the public are primarily issued by the Department of the Treasury and include:

- Interest bearing marketable securities: bills, notes and bonds.
- Interest bearing non-marketable securities: foreign government series, State and local government series, domestic series and savings bonds.
- Non-interest bearing debt: matured and other debt.

As of September 30, 1997, most Federal debt ($5,328 billion) was subject to a statutory limit (31 U.S.C. 3101), which was $5,950 billion. The debt subject to the limit includes debt held by the public and intragovernmental holdings, less most debt of Federal agencies, the Federal Financing Bank debt and miscellaneous debt, and the unamortized net premiums on intragovernmental holdings, plus unamortized net discounts on public issues of Treasury notes and bonds (other than zero-coupon bonds).

Note 10. Federal employee and veteran benefits payable

The Federal Government offers its employees, both civilian and military, retirement benefits, life and health insurance, and other benefits.

The Federal Government administers more than 40 pension plans. The largest are administered by OPM for civilian employees and by the Department of Defense (DOD) for military personnel. The Federal Government has both defined benefit and defined contribution pension plans, although the largest are defined benefit plans.

Civilian employees

Pensions

The largest civilian pension plan is administered by OPM and covers approximately 90 percent of all Federal

Federal employee and veteran benefits payable as of September 30

(In billions of dollars)

Civilian employees:	
Pensions	977.2
Health benefits	158.9
Other benefits	29.2
Total Federal employee benefits	1,165.3
Military employees:	
Pensions	641.7
Compensation and burial benefits	197.4
Health benefits	218.0
Other benefits	21.3
Total military benefits	1,078.4
Total Federal employee and veteran benefits payable	2,243.7

Change in actuarial accrued pension liability and components of related expense

(In billions of dollars)	Civilian employees[1]	Military employees
Actuarial accrued pension liability, as of September 30, 1996	911.3	625.8
Pension expense:		
Normal costs	19.7	11.1
Interest on unfunded liability	63.0	40.1
Actuarial gains (-)/losses	-10.5	-5.0
Total pension expense	72.2	46.2
Benefits paid	-41.3	-30.3
Actuarial accrued pension liability, as of September 30, 1997	942.2	641.7

[1] OPM only.

Significant assumptions used in determining the pension liability and the related expense include:

	Civilian employees	Military employees
Rate of interest	7.00%	6.50%
Rate of inflation	4.00%	3.50%
Projected salary increases	4.25%	4.00%

Change in accrued post-retirement health benefits liability and components of related expense

(In billions of dollars)	Civilian employees	Military employees
Actuarial post-retirement health benefits liability, as of September 30, 1996	148.6	210.3
Post-retirement health benefits expense:		
Normal costs	5.5	5.2
Interest on unfunded liability	10.5	14.3
Actuarial gains (-)/losses	-	-4.9
Total post-retirement health benefit expense	16.0	14.6
Claims paid	-5.7	-6.9
Actuarial accrued post-retirement health benefits liability, as of September 30,1997	158.9	218.0

Significant assumptions used in determining the post-retirement health benefits liability and the related expense include:

	Civilian employees	Military employees
Rate of interest	7.00%	6.75%
Rate of health care inflation	7.00%	2.50-8.00%

civilian employees. It includes two components of defined benefits: the Civil Service Retirement System (CSRS) and the Federal Employee's Retirement System (FERS). The basic benefit components of CSRS and FERS are financed and operated through the Civil Service Retirement and Disability Fund (CSRDF). CSRDF monies are generated primarily from employees, agency contributions, payments from the general fund and interest on investments in Federal debt securities (see Note 16, under CSRDF, for further discussion).

The Federal Retirement Thrift Investment Board is an independent Government agency that operates the Thrift Savings Plan. The fund's assets are owned by the Federal employees and retirees covered by CSRS and FERS. For this reason, the fund is excluded from the consolidated financial statements and the fund's holdings of Federal debt are considered part of the Federal debt held by the public rather than Federal debt held by the Government. FERS employees may contribute up to 10 percent of their base pay to the plan, which is matched by the Government up to 5 percent. CSRS employees may contribute up to 5 percent of their base pay with no Government match.

The Thrift Savings Plan's total investment, as of September 30, 1997, was $51.5 billion. Investments include U.S. Government non-marketable securities ($24.8 billion), which are included in total Federal debt securities held by the public in the balance sheet.

Health benefits

Civilian retirees pay the same insurance premium as active employees under the Federal Employee Health Benefits Program (FEHBP). These premiums cover only a portion of the costs. Although the Government contribution for the premiums of active employees in FEHBP is paid by the employing agency, the Government contribution for civilian retirees is funded through appropriations.

Other benefits

The Federal Employees Group Life Insurance program is largely funded by employee contributions. The employees life insurance program finances payments to private insurance companies for Federal employee's group life insurance and is administered by OPM.

Military employees (including veterans)

Pensions

The DOD Military Retirement Trust Fund accumulates funds in order to finance liabilities of DOD under military retirement and survivor benefit programs. The fund provides retirement benefits for military personnel and their survivors.

The military retirement system applies to the Army, Navy, Marine Corps and Air Force. The system is a funded, non-contributory, defined benefit plan. It includes non-disability retired pay, disability retired pay, retired pay for reserve service and survivor annuity programs.

Compensation and burial benefits

Veterans compensation is payable as a disability benefit or a survivor's benefit. Entitlement to compensation depends on the veteran's disabilities incurred in, or aggravated during active military service, death while on duty or death resulting from service connected disabilities, if not in active duty.

Burial benefits include a burial and plot or interment allowance payable for a veteran who, at the time of death, was entitled to receive compensation, pension or whose death occurred in a VA facility.

Veterans compensation and burial benefits payable as of September 30

(In billions of dollars)

Veterans	158.5
Survivors	37.1
Burial benefits	1.8
Total veterans compensation and burial benefits payable	197.4

Health benefits

Military retirees and their dependents are entitled to health care in military medical facilities if the facility can provide the needed care. Until they reach age 65, military retirees and their dependents also are entitled to health care financed by the Civilian Health and Medical Programs of the Uniformed Services (CHAMPUS). No premium is charged for CHAMPUS financed care, but there are deductible and copayment requirements. After they reach 65 years of age, military retirees are entitled to Medicare.

The costs for military retiree health care include costs of buildings, equipment, education and training, staffing, operations and maintenance of military medical treatment facilities. They also consist of claims paid by CHAMPUS and the administration of the program.

Other benefits

VA insurance includes the following programs: United States Government Life Insurance, National Service Life Insurance, Veterans Insurance and Indemnities, Veterans Special Life Insurance, Veterans Reopened Insurance, Service Disabled Veterans Insurance and Servicemen's Group Life Insurance.

The National Service Life Insurance was established in 1940 for the World War II servicemen and veterans and remained open until 1951. Of the original 22 million policies issued, approximately 2 million remain. Under this program the maximum coverage is limited to $10,000.

Veterans Special Life Insurance was established in 1951 for servicemen who served in the Korean War and the post-Korean period through 1957. Approximately 800,000 policies were issued of which, 252,300 remain.

Note 11. Environmental liabilities

Environmental liabilities as of September 30

(In billions of dollars)

Environmental management and legacy waste	141.3
Defense: clean-up costs	27.8
Active facilities	20.7
Pipeline facilities	8.8
High-level waste	6.7
Other environmental liabilities	6.4
Total environmental liabilities	211.7

During World War II and the Cold War, the United States developed a massive industrial complex to research, produce and test nuclear weapons. The nuclear weapons complex included nuclear reactors, chemical processing buildings, metal machining plants, laboratories and maintenance facilities. The resulting environmental liabilities are the costs associated with removing, containing and/or disposing of hazardous waste from the properties. "Environmental liabilities," as used in this report, applies only to cleanup costs from Federal operations known to result in hazardous waste, which the Federal Government is required by Federal, State or local statutes, and/or regulations that have been approved as of the balance sheet date regardless of the effective date of cleanup.

The DOD is responsible for cleaning up and disposing of hazardous materials in facilities it operates or has operated and has recorded a $27.8 billion liability for these costs. DOD has not currently recorded any liability for national defense assets (primarily disposal of weapon systems like aircraft, ships and submarines) and ammunitions (primarily hazardous materials).

"Environmental management and legacy wastes" include costs for environmental restoration, nuclear material and facility stabilization, and waste treatment, storage and disposal activities at each installation. It also includes costs for related activities such as landlord responsibilities, program management and legally prescribed grants for participation and oversight by Native American tribes, and regulatory agencies. "Active facilities" represent anticipated remediation costs for those facilities that are conducting ongoing operations but will ultimately require stabilization, deactivation and decommissioning.

Projects with no current feasibility remediation approach are excluded from the estimate. Significant projects not included are:

- Nuclear explosion test areas (such as the Nevada test site).
- Large surface water bodies (such as the Clinch and Columbia rivers).
- Most ground water (even with treatment, future use will be restricted).
- Some special nuclear material (such as uranium hexafluoride).

Note 12. Benefits due and payable

Benefits due and payable as of September 30

(In billions of dollars)

Federal Old-Age and Survivors Insurance	28.1
Federal Hospital Insurance (Medicare, Part A)	16.9
Grants to States for Medicaid	14.1
Federal Supplemental Medical Insurance (Medicare, Part B)	10.5
Federal Disability Insurance	6.2
Other benefits due and payable	1.9
Total benefits due and payable	77.7

These amounts are benefits owed to the recipients or medical service providers of the above programs as of the fiscal yearend but not yet paid. For a description of the programs, see the supplemental information in Section 4, under Social Security and Medicare.

"Other Benefits due and payable" include unemployment benefits, Black Lung benefits and Railroad Retirement pension benefits.

Note 13. Other liabilities

Other liabilities as of September 30

(In billions of dollars)

Deferred revenue	27.2
Contingent liabilities	16.9
Exchange Stabilization Fund	15.9
Insurance programs	14.6
Accrued wages and benefits	12.8
Advances from others	6.8
Other	74.6
Total other liabilities	168.8

"Deferred revenue" is revenue received but not yet earned. "Contingent liabilities" are the estimated value of probable losses. "Exchange Stabilization Fund" includes SDR certificates issued to the Federal Reserve banks and allocations from the International Monetary Fund. "Insurance program" liabilities include bank deposit insurance, guarantees of pension benefits, life insurance, medical insurance and insurance against damage to property (home, crops and airplanes) caused by perils such as flooding and other natural disasters, war-risk and insolvency. "Accrued wages and benefits" are the estimated liability for salaries and wages of civilian and commissioned officers that have been earned but are unpaid, and amounts of funded annual leave and other employee benefits that have been earned but are unpaid. "Advances from others" are amounts received for goods and services to be furnished. "Other" liabilities include gold certificates issued to the Federal Reserve banks, other actuarial liabilities, deposit funds and suspense accounts.

Note 14. Commitments and contingencies

The Federal Government's commitments and contingencies include long-term leases, loan and credit guarantees, and deposit and pension insurance. They do not include commitments for long-term procurements.

FASAB standards require disclosure of contingencies when a loss is considered to be more likely than not, but less than probable, and when the amount of possible loss can be reasonably estimated, or when the loss is probable but the amount is not measurable.

For the fiscal year ended September 30, 1997, the amount of possible loss contingencies was not available for consolidation. Therefore, the amounts stated here represent the maximum theoretical risk exposure. However, it is not likely that the maximum loss will be incurred.

In fiscal 1998, contingencies will be reported using the basis prescribed by FASAB Statement No. 5.

The U.S. Government is also subject to other contingencies, including litigation, that arise in the normal course of operations. Although there can be no assurance as to the ultimate disposition of these matters, it is management's opinion, based upon information currently available, that the expected outcome of these matters, individually or in the aggregate, except for the following litigation, will not have a material adverse affect on the consolidated financial statements.

The U.S. Court of Federal Claims has not yet imposed any damage awards against the United States in any of the 125 supervisory goodwill cases. However, while it is likely that the United States will have to pay some amount of damages on the claims, the ultimate costs cannot be reasonably estimated at this time.

Commitments and contingencies as of September 30

(In billions of dollars)

Commitments	
Long-term leases:	
General Services Administration	13.6
U.S. Postal Service	2.9
Other long-term leases	4.9
Total commitments	21.4
Contingencies	
Insurance:	
FDIC bank insurance fund	2,028.0
FDIC savings association insurance fund	684.3
Department of Veteran Affairs	24.0
National Credit Union Administration	2.8
Department of Transportation	2.0
Other insurance	32.7
Total insurance	2,773.8
Government loan and credit guarantees:	
Department of Housing and Urban Development	447.1
Department of Education	99.0
Department of Veteran Affairs	69.4
Small Business Administration	25.2
Export-Import Bank	22.1
Department of Agriculture	17.5
Other Government loan and credit guarantees	32.1
Total Government loan and credit guarantees	712.4
Unadjudicated claims:	
Department of Transportation	80.9
Department of Health and Human Services	0.9
Other unadjudicated claims	25.9
Total unadjudicated claims	107.7
Other contingencies:	
Department of Housing and Urban Development	8.3
Other contingencies	129.5
Total other contingencies	137.8
Total contingencies	3,731.7
Total commitments and contingencies	3,753.1

Note 15. Unreconciled transactions affecting the change in net position

The reconciliation of the "change in net position" requires that the difference between ending and beginning net position equals the excess of cost over revenues plus or minus prior period adjustments. The unreconciled transactions needed to bring the change in net position into balance net to $12.4 billion. The three primary factors affecting this out-of-balance situation are (1) agency misclassification of intragovernmental transactions; (2) changes in valuation of balance sheet assets and liabilities, which were not identified by agencies as prior period adjustments; and (3) timing differences and errors in the reporting of transactions.

The identification and reporting of these unreconciled transactions are a priority project of the financial community within the Federal Government.

Note 16. Dedicated collections

The term "trust fund," as used in this report and in Federal budget accounting, is frequently misunderstood. In the private sector, "trust" refers to funds of one party held by a second party (the trustee) in a fiduciary capacity. In the Federal budget, the term "trust fund" means only that the law requires the funds be accounted for separately and used only for specified purposes and that the account was designated as a "trust fund." A change in law may change the future receipts and the terms under which the fund's resources are spent.

The "trust fund assets" represent all sources of receipts and amounts due the trust fund regardless of source. This includes "related governmental transactions," which are transactions between two different entities within the Federal Government (for example, monies received by one entity of the Government from another entity of the Government).

The "intragovernmental assets" are comprised of investments in Federal debt securities, related accrued interest and fund balance with Treasury. These amounts are eliminated in preparing these consolidated financial statements.

The "consolidated assets" represent only the amounts due from individuals and other entities outside the U.S. Government. This means that all related governmental transactions are removed to give a view of the U.S. Government's position as a whole.

The majority of the funds' assets are invested in intragovernmental Federal

Dedicated collections as of September 30

(In billions of dollars)	Receipts	Disbursements	Assets: Trust fund	Assets: Less: Intragovernmental	Assets: Consolidated
Federal Old Age and Survivors Insurance Trust Fund...........	387.5	318.4	577.5	577.5	-
Federal Disability Trust Fund......	60.3	46.6	64.6	64.6	-
Hospital Insurance Trust Fund (Medicare, Part A) ...	128.3	137.7	118.9	118.9	-
Supplementary Medical Insurance (Medicare, Part B).............	81.0	73.5	35.1	35.1	-
Unemployment Trust Fund	32.6	24.4	63.1	63.1	-
Hazardous Substance Superfund	0.7	1.4	5.6	5.6	-
Highway Trust Fund.............	25.3	24.5	22.3	22.3	-
Airport and Airway Trust Fund	4.7	5.8	6.5	6.5	-
Civil Service Retirement and Disability Fund............	70.4	72.7	430.9	430.6	0.3
Military Retirement Fund.........	26.2	46.1	143.2	143.2	-

debt securities. These securities will require redemption if a fund's disbursements exceed its receipts. Redeeming these securities will increase the Government's financing needs and require increased borrowing from the public.

By law, certain expenses (costs) related to the administration of the above funds are not charged to the funds and are financed by other financing sources.

Federal Old Age and Survivors Insurance Trust Fund

The fund provides assistance and protection against the loss of earnings due to retirement or death. The assistance is in the form of money payments or medical care. The Federal Old Age and Survivors Trust Fund is administered by the Social Security Administration (SSA).

The Federal Old Age and Survivors Insurance Fund is financed primarily by payroll taxes. The fund also receives additional income from interest earnings on Federal debt securities, Federal agencies' payments for the Social Security benefits earned by military and Federal civilian employees, and Treasury payments for a portion of income taxes paid on Social Security benefits.

Federal Disability Trust Fund

The Federal Disability Trust Fund provides assistance and protection against the loss of earnings due to a wage earner's disability. The assistance is in the form of money payments or medical care. The Federal Disability Trust Fund is administered by SSA.

The Federal Disability Trust Fund, like the Federal Old Age and Survivors Insurance Trust Fund, is financed primarily by payroll taxes. The fund also receives additional income from interest earnings on Federal debt securities, Federal agencies' payments for the Social Security benefits earned by military and Federal civilian employees, and a portion of income taxes paid on Social Security benefits.

Federal Hospital Insurance Trust Fund

The Hospital Insurance Trust Fund finances the Hospital Insurance Program, which funds the cost of hospital and related care for individuals age 65 or older who meet certain insured status requirements, and for eligible disabled people. The program is administered by the Department of Health and Human Services (HHS).

The Hospital Insurance Trust Fund (also known as Medicare, Part A) is financed primarily by payroll taxes. It also receives additional income from interest earnings on Federal debt securities, Federal agencies' payments for the Social Security benefits earned by military and Federal civilian employees, and a portion of income taxes paid on Social Security benefits.

Federal Supplemental Medical Insurance Trust Fund

The Supplemental Medical Insurance Trust Fund (also known as Medicare, Part B) provides supplementary medical insurance for eligible participants to cover medical expenses not covered by Medicare, Part A. The program is administered by HHS.

The Supplemental Medical Insurance Trust Fund is funded by appropriations, premiums charged to enrollees and interest earned on investments in Federal debt securities.

Unemployment Trust Fund

The Unemployment Trust Fund protects workers who lose their jobs through no fault of their own. Unemployment insurance is a unique Federal/State partnership based on Federal law, which is executed through State law by State officials. The program is administered by the Department of Labor.

The Unemployment Trust Fund is funded primarily by taxes on employers. However, it also has income from interest earned on investments in Federal debt securities and appropriations have supplemented its income during periods of high and extended unemployment.

Hazardous Substance Superfund

The Hazardous Substance Superfund was authorized to address public health and environmental threats from spills of hazardous materials and from sites contaminated with hazardous substances. The fund is administered by the Environmental Protection Agency.

The Hazardous Substance Superfund is financed by excise taxes collected on petroleum and chemicals, environmental taxes from all corporations with income in excess of $2 million and interest earned on investments in Federal debt securities.

Highway Trust Fund

The Highway Trust Fund was established to promote domestic interstate transportation, moving people and transporting goods. The fund provides Federal grants to States for highway construction and related transportation purposes. The Highway Trust Fund is administered by the Department of Transportation.

The Highway Trust Fund is financed entirely by earmarked taxes on gasoline and other fuels, certain tires, vehicle and truck use, and by interest earned on investments in Federal debt securities.

Airport and Airway Trust Fund

The Airport and Airway Trust Fund provides for airport improvement, maintenance of the facilities and equipment, research and also for a portion of the operations. The Airport and Airway Trust Fund is administered by the Department of Transportation.

The Airport and Airway Trust Fund is financed by taxes received from transportation of persons and property in the air, fuel used in non-commercial aircraft, international departure taxes and by interest earned on investments in Federal debt securities.

Civil Service Retirement and Disability Fund

CSRDF covers two Federal civilian retirement systems: CSRS, for employees hired before 1984 and FERS, for employees hired after 1983.

CSRDF is financed by Federal civilian employees' contributions, agencies' contributions on behalf of the employees, appropriations and interest earned on investments in Federal debt securities.

Military Retirement Trust Fund

The Military Retirement Trust Fund provides retirement benefits for Army, Navy, Marine Corps and Air Force personnel and their survivors. The fund is financed by DOD contributions, appropriations and interest earned on investments in Federal debt securities.

Note 17. Fiduciary trust funds

The fiduciary trust funds differ from other dedicated collections reported in Note 16, in that the Federal Government holds fiduciary funds on behalf of some other entity (for example, individual, tribes and foreign governments). No person or group of persons has a direct ownership interest in the monies held by the trust funds reported in Note 16.

The U.S. Federal Government has a fiduciary responsibility for several deposit and trust funds. The Department of the Interior has responsibility for the assets held in trust on behalf of American Indian Tribes and individuals. The fiduciary funds are held in accounts for approximately 315 tribes, 317,000 individual Indian accounts and other funds, including the Alaska Native Escrow Fund. The assets held in trust for Native Americans are owned by the trust beneficiaries and are not Federal assets. Therefore, these amounts are not reflected in the consolidated balance sheet or statement of net costs.

Fiduciary trust fund balances presented below do not include trust land managed by the U.S. Government.

U.S. Government as trustee for Indian fiduciary trust funds statement of changes in trust fund balances as of September 30 (unaudited)

(In billions of dollars)

Receipts	1.2
Disbursements	1.0
Receipts in excess of disbursements	0.2
Trust fund balances, beginning of year	2.7
Trust fund balances, end of year	2.9

United States Government Consolidated Stewardship Reporting for the year ended September 30, 1997 (Unaudited)

The stewardship reporting section of this report provides information on certain resources entrusted to the Federal Government and certain responsibilities assumed by it. These resources and responsibilities do not meet the criteria for assets and liabilities that are required to be reported in the financial statements but are important to understanding the operations and financial condition of the Federal Government. The section this year includes information on land not used in general operations and on major social insurance programs: Social Security and Medicare parts A and B. The scope of this section will be expanded in the future.

The information on social insurance is supplemented by Note 16. Social insurance is financed through trust funds, and Note 16 provides general information about the nature of dedicated collections and trust funds in the Federal Government and specific information about the receipts, disbursements and assets of the largest funds with dedicated collections.

Stewardship land

Stewardship land is land owned by the Federal Government not used in, or held for use in, general government services. Therefore, excluded from stewardship lands are lands used as part of general government operations (e.g. military bases and the Tennessee Valley Authority), and lands administered by the Bureau of Indian Affairs held in trust on behalf of the Indians.

The majority of stewardship land is "public domain" land — that is, large areas of territory acquired by the nation between 1781 and 1867. All areas of the nation other than the lands belonging to the original 13 colonies and the state of Texas were acquired as public domain. During this time, the Federal Government acquired land equal to 79.4 percent of the current acreage of the United States, spending a total of $85.1 million.

Bureau of Land Management

The Bureau of Land Management (BLM) is responsible for managing a variety of land types. BLM subdivides their management responsibility into five primary land types: (1) rangeland; (2) forest land; (3) riparian and wetlands; (4) aquatic areas and (5) other habitat and wastelands.

Rangeland is land on which the native vegetation is predominately grasses, grass-like plants, forbs, or shrubs suitable for grazing or browsing use. Rangelands include lands revegetated either naturally or artificially to provide a forage cover that is managed like native vegetation. Rangelands in-

United States Government stewardship land as of September 30
(In millions of acres)

Predominate land use	U.S. Forest Service	National Park Service	U.S. Fish and Wildlife Service	Bureau of Land Management	Totals: Total by type of use	Totals: Percent of total
Bureau of Land Management land..				259.0	259.0	41%
National wildlife refuge.............			67.4		67.4	11%
National parks		49.4			49.4	8%
National forest	153.3				153.3	25%
National grassland ...	3.8				3.8	1%
Wilderness area......	34.7	28.0	20.7	5.0	88.4	14%
Total acres.........	191.8	77.4	88.1	264.0	621.3	100%

clude natural grasslands, savannahs, shrublands, most deserts, tundra, alpine communities, coastal marshes and wet meadows. Rangelands total 165 million acres, including 5 million acres in the Alaska Reindeer Range.

Forest land encompasses approximately 11 million acres. About 7 million acres are in Alaska, with 4 million more in the 11 western states. These forested lands are of great variety and include black and white spruce in Alaska; aspen, lodgepole pine, ponderosa pine, interior Douglas fir, and associated species of the Intermountain West; the pinyon-juniper woodlands of the Great Basin and Southwest; and the Douglas fir, hemlock, and cedar forests of western Oregon and northern California.

Riparian areas are lands adjacent to creeks, streams, lakes, and rivers totaling 183,000 miles in length and 7 million acres in area. These areas, containing scarce water and vegetation in the otherwise arid western United States, are important to fish and wildlife species, as well as to livestock. Since they filter the water flowing through them, riparian-wetland areas can effect the health of the entire watersheds. Wetlands are areas inundated or saturated by surface or ground water at a frequency and duration sufficient to support vegetation that is typically adapted for life in saturated soil. Wetlands include bogs, marshes, shallows, muskegs, wet meadows, estuaries and riparian areas. Wetlands total 16 million acres.

Aquatic areas are areas of water flow or standing water that include about 4 million acres of lakes and reservoirs. These waters contain a wide variety of aquatic species that range from rare resident species, such as the desert pupfish to endangered and threatened anadromous species, such as steelhead and chinook salmon.

Wastelands are areas that generally do not provide forage in sufficient amounts to sustain wildlife or grazing animals. This land category includes such areas as mountain tops, glaciers, barren mountains, sand dunes, playas, hot, dry deserts and other similar areas totaling 20 million acres.

U.S. Forest Service

The U.S. Forest Service has the responsibility for the management of 191.8 million acres of Federally owned lands for the sustained use of outdoor recreation, range, timber, watershed, and the management of wildlife and fish.

Forest land contains 155 named national forests. Within the national forests, livestock grazing for cattle, horses, sheep and goats was permitted on over 103.4 million acres of rangeland. The Forest Service sold 4.0 billion board-feet of lumber and supervised the harvest of 3.3 billion board-feet of lumber in the fiscal 1997 and reforested 0.3 million acres primarily with genetically improved seedlings.

Wilderness land contains 34.7 million acres in 44 states, Puerto Rico and the U.S. Virgin Islands, and is served by 33,000 miles of trails.

The Forest Service also manages 20 named grasslands on 3.8 million acres and about 4,348 miles of the wild and scenic river system.

U.S. Fish and Wildlife Service

The U.S. Fish and Wildlife Service has the responsibility for the management of 88.1 million acres of Federally owned lands held primarily for wildlife conservation. It has four goals: (1) to preserve, restore, and enhance in their natural ecosystems all species of animals and plants that are endangered or threatened with becoming endangered; (2) to perpetuate the migratory bird resource; (3) to preserve a natural diversity and abundance of fauna and flora and (4) to provide and understanding and appreciation of fish and wildlife ecology, and to provide refuge visitors a safe, wholesome and enjoyable recreational experience oriented toward wildlife.

The U.S. Fish and Wildlife Service subdivides its management responsibility into the following categories:

- National wildlife refuges-512 sites on 67.4 million acres and
- Wilderness areas-362 sites on 20.7 million acres.

The service also manages eight wild and scenic rivers totaling 1,390 miles in length.

National Park Service

The National Park Service has the responsibility for the management of 77.4 million acres of Federally owned lands, including 13.1 million acres designated as wilderness, the purpose of which is to conserve the scenery, nature, historic objects and the wildlife therein for the enjoyment of the public and future generations.

Other types of park areas include: national rivers, parkways, national lakeshores, historic parks, scenic trails, wild and scenic rivers, military parks, reserves, battlefields and other parks.

Summary of acreage

(In millions of acres)

Type of park area	Acreage
National parks	49.4
National preserves	21.4
National recreation areas	3.3
National monuments	1.7
National seashores	0.5
Other park areas	1.1
Total acres	77.4

Stewardship responsibilities

Social Security

The Social Security Act was enacted in 1935 and included, among other elements, programs providing benefits for retirement.

Two trust funds have been established by law to account for the OASI and the DI programs. OASI pays retirement and survivors benefits and DI pays benefits after a worker becomes disabled.

Revenue to OASDI consists of taxes on earnings that are paid by employees, their employers and the self-employed. OASDI also receives revenue from the taxation of part of Social Security benefits. Revenues that are not needed to pay current benefits or administrative expenses are invested in special issue U.S. Government securities guaranteed as to both principal and interest and backed by the full faith and credit of the U.S. Government.

The Board of Trustees of the OASI and DI Trust Funds provides the President and the Congress with short-range (10 year) and long-range (75-year) actuarial estimates of each trust fund in its annual report. Because of the inherent uncertainty in estimates for as long as 75 years into the future, SSA Trustees use three alternative sets of economic and demographic assumptions to show a range of possibilities. Assumptions are made about many economic, demographic, and programmatic factors, including gross domestic product, earnings, the Consumer Price Index, unemployment, fertility, immigration, mortality, and disability incidents and termination. The assumptions used in the table below, generally referred to as the intermediate assumption, reflect the best estimate of expected future experience.

The present values of actuarial estimates have been computed as of the beginning of the valuation period, September 30, 1997. The expenditures consist of the sum of the present value of all estimated payments during the 75-year valuation period, and the contributions consist of the sum of the present value of all estimated non-interest income during the period. The estimates have been prepared on the basis of the financing method regarded by both the Congress and the trustees of the trust funds as the appropriate one to use for social insurance programs—namely that future workers will be covered by the program as they enter the labor force.

Under current legislation and using intermediate assumptions, the DI trust fund and the OASI trust fund are projected to be exhausted in 2015 and 2031 respectively. Combined OASDI expenditures will exceed current tax income beginning in 2012, and they will exceed total current income (including current interest income) for calendar years

Social Security present value (PV) actuarial estimates for the period of 75 years into the future, beginning September 30, 1997

(In trillions of dollars)

	OASI	DI	OASDI
PV of actuarial contributions to the year 2072	15.3	2.5	17.8
PV of actuarial expenditures to the year 2072	18.2	3.1	21.3
PV of future resources needed	2.9	0.6	3.5
Net assets of Social Security (as of September 30, 1997)	0.6	0.1	0.7

2019 and later. Thus, current tax income plus a portion of annual interest income will be needed to meet expenditures for the years 2012 through 2018. Thereafter, in addition to current tax income and current interest income, a portion of the principal (i.e., combined OASDI assets) will be needed each year until the trust fund assets are totally exhausted in 2029. At that point, current tax income will be sufficient to pay approximately 75 percent of the benefits due.

Medicare

Revenue to Federal Hospital Insurance Trust Fund (HI–Medicare, Part A) consists of taxes on earnings that are paid by employees, their employers, and the self-employed. HI also receives revenue from part of the taxation of Social Security benefits and from interest on its investments. Revenues that are not needed to pay current benefits or administrative expenses are invested in special issue U.S. Government securities guaranteed as to both principal and interest and backed by the full faith and credit of the U.S. Government.

HI (Medicare, Part A) has an actuarial deficit of $1,845.3 billion as computed 25 years (to calendar year 2022) into the future. It includes the book value of assets as of September 30, 1997, and the present value of various program income items expected to be received through the year 2022, less: (1) the present value of outlays through the year 2022, (2) claims incurred to October 1, 1997, but unpaid as of that date, and (3) any administrative expenses related to those claims. Under current legislation, incorporating the changes from the Balanced Budget Act, and using intermediate assumptions from the 1997 trustees report, Medicare, Part A is projected to be exhausted in 2010.

The Federal Supplementary Medical Insurance Trust Fund (SMI—Medicare, Part B) benefits and administrative expenses are financed by monthly premiums paid by Medicare beneficiaries and additional contributions by the Federal Government. The Omnibus Budget Reconciliation Act of 1990 set specific monthly premium levels for five calendar years beginning in 1991. The monthly premium in calendar year 1997 covered 25 percent of the SMI program's estimated 1997 cost.

The Federal Supplementary Medical Insurance Trust Fund (SMI—Medicare, Part B) has a surplus of $29,237 billion which represents the amount of the estimated book value of the trust fund assets as of September 30, 1997, less unpaid benefits and related administrative expenses.

The Federal Accounting Standards Advisory Board is considering adding three other social insurance programs for presentation in future consolidated statements as stewardship responsibilities: the Railroad Retirement Trust Fund, the Black Lung Trust Fund and the Unemployment Insurance Program.

Medicare, Part A, present value estimates for the period of 25 years into the future, beginning September 30

(In billions of dollars)

PV of actuarial contributions to the year 2022	2,432.8
PV of actuarial expenditures to the year 2022	4,278.1
PV of future resources needed	1,845.3
Assets in Medicare Trust Fund	118.9

Medicare Part B, estimates as of September 30

(In billions of dollars)

Total trust fund assets	35.1
Total unpaid benefits	6.0
Excess of Trust Fund assets over unpaid benefits	29.1

United States Government
Consolidated Supplemental Information
for the year ended September 30, 1997

Reconciliation of the changes in net position to the deficit on the budgetary basis for the year ended September 30 (Unaudited)

(In billions of dollars)

Change in net position	-2.6
Timing and other differences in the recognition or measurement of revenue:	
Earned revenue	-102.0
Non-exchange revenue	-3.2
Other earned revenue	-11.6
Timing and other differences in the recognition or measurement of cost:	
Defense	-18.6
Human resources	-34.3
Physical resources	123.3
Interest	2.1
Other functions	37.4
Non-recurring items:	
Unreconciled transactions affecting the change in net position	-12.4
Deficit (-) for the year on the budgetary basis	-21.9

Appendix: List of significant U.S. Government entities included and entities excluded from these Consolidated Financial Statements

These financial statements include the executive, legislative and judicial branches of the Federal Government. Excluded from this consolidated financial statement are privately owned Government sponsored enterprises such as the Federal Home Loan Banks and the Federal National Mortgage Association. The Federal Reserve System is also excluded because organizations and functions pertaining to monetary policy are traditionally separate from and independent of the other central Government organizations and functions.

Significant entities included in this consolidation

Executive Office of the President
Office of Management and Budget
Department of Agriculture
Department of Commerce
Department of Defense
Department of Education
Department of Energy
Department of Health and Human Services
Department of Housing and Urban Development
Department of the Interior
Department of Justice
Department of Labor
Department of State
Department of the Air Force
Department of the Army
Department of the Navy
Department of the Treasury
Department of Transportation
Department of Veterans Affairs
U.S. Postal Service
Agency for International Development
Central Intelligence Agency
Commodity Credit Corporation
Commodity Futures Trading Commission
Corporation for Public Broadcasting
Environmental Protection Agency
Export-Import Bank of the United States
Farm Credit Administration
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Emergency Management Agency
Federal Trade Commission
General Services Administration
National Aeronautics and Space Administration
National Archives and Records Administration
National Credit Union Administration
National Science Foundation
National Transportation Safety Board
Office of Personnel Management
Pension Benefits Guarantee Corporation
Securities and Exchange Commission
Small Business Administration
Smithsonian Institution
Social Security Administration
Tennessee Valley Authority
U.S. Nuclear Regulatory Commission
U.S. Army Corps of Engineers
U.S. Information Agency
Other boards and commissions
Library of Congress
Government Printing Office
General Accounting Office
Congressional Budget Office
Other legislative and judicial (cash transactions only)

Significant entities excluded from this consolidation

Federal Reserve Banks
Board of Governors of the Federal Reserve System
Farm Credit System
Thrift Savings Plan
Federal Home Loan Banks
Financing Corporation
Freddie Mac
Fannie Mae
Sallie Mae
Resolution Funding Corporation
Army and Air Force Exchange Service
Navy Exchange Service Command
Marine Corps Exchange

GMRA Financial Management Status Report

Federal Departments and Agencies

	RELIABLE FINANCIAL INFORMATION (yes/qualified/no)	EFFECTIVE INTERNAL CONTROL (yes/no)	COMPLIANCE WITH LAWS AND REGULATIONS (yes/no)	GRADE FY 96	GRADE FY 97
DOE Department of Energy	YES	YES	YES	A	**A**
NASA National Aeronautics and Space Administration	YES	YES	YES	A	**A**
NSF National Science Foundation	Qualified	YES	YES	D	**B+**
GSA General Services Administration	YES	YES	NO	D+	**B-**
Labor Department of Labor	YES	YES	NO	D	**B-**
NRC Nuclear Regulatory Commission	YES	YES	NO	A	**B-**
SSA Social Security Administration	YES	YES	NO	A	**B-**
EPA Environmental Protection Agency	YES	NO	NO	C	**D+**
SBA Small Business Administration	YES	NO	NO	B-	**D+**
HUD Department of Housing and Urban Development	Qualified	NO	NO	D-	**D-**
Treasury Department of the Treasury	Qualified	NO	NO	F	**D-**
AID Agency for International Development	NO	NO	NO	F	**F**
DOD Department of Defense	NO	NO	NO	F	**F**
Justice Department of Justice	NO	NO	NO	F	**F**
OPM Office of Personnel Management	NO	NO	NO	F	**F**
Agriculture Department of Agriculture	No report	No report	No report	F	**INC**
Commerce Department of Commerce	No report	No report	No report	F	**INC**
DOT Department of Transportation	No report	No report	No report	F	**INC**
Education Department of Education	No report	No report	No report	D+	**INC**
FEMA Federal Emergency Management Agency	No report	No report	No report	F	**INC**
HHS Health and Human Services	No report	No report	No report	F	**INC**
Interior Department of the Interior	No report	No report	No report	F	**INC**
State Department of State	No report	No report	No report	D-	**INC**
VA Department of Veterans Affairs	No report	No report	No report	F	**INC**

NOTE:

Grades are based on the audited financial statements prepared under the Government Management Reform Act of 1994 for agencies for three categories : RELIABLE FINANCIAL INFORMATION (UNQUALIFIED OPINION), EFFECTIVE INTERNAL CONTROLS, and COMPLIANCE WITH LAWS AND REGULATIONS.

Prepared for Subcommittee Chairman Stephen Horn — April 1, 1998

Subcommittee on Government Management, Information, and Technology — Subcommittee Home Page on the Internet : http://www.house.gov/reform/gmit.htm

OVERSIGHT OF THE INTERNAL REVENUE SERVICE: THE COMMISSIONER REPORTS TO CONGRESS

WEDNESDAY, APRIL 15, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Davis of Virginia, and Kucinich.

Staff present: J. Russell George, staff director and chief counsel; Mark Brasher, senior policy director; John Hynes, professional staff member; Matthew Ebert, clerk; Mason Alinger, staff assistant; and Faith Weiss, minority counsel.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will come to order.

Each year on this day, April 15, the Internal Revenue Service holds individuals accountable for the accurate reporting of their tax liability. It is fitting that today we hold the IRS accountable as well. In past years, this subcommittee has held similar hearings and heard reports of mismanagement at the IRS ranging from its inability to provide reliable financial information to poor debt collection practices. I am pleased that the IRS has made great progress in allowing its auditors to render, for the first time, a clean opinion on its financial statements.

We know that a lot more remains to be done. Today, we'll discuss with Commissioner Rossotti his plans to revamp the Internal Revenue Service's organizational structure. We will review the results of the most recent financial audit with the General Accounting Office. In addition, we will hear from several witnesses that represent taxpayers on their views on improving the Internal Revenue Service's management. And it's a pleasure to welcome Commissioner Rossotti in his first appearance before this subcommittee.

Last year, I wrote the President and asked Mrs. Maloney, the then ranking Democrat, to join me in that, and we said, "Mr. President, in essence, we have had some wonderful tax accountants. We've had some wonderful tax lawyers. Why don't you get somebody that has run an organization and been an executive?" And I must say I'm delighted with the President's choice, Secretary Rubin's choice, they made an outstanding selection in the gentleman that we have before us. I'd like to defer to my colleague, Tom Davis of Virginia, who will introduce Commissioner Rossotti, whom he's known for a number of years.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. It's really a pleasure to be here. Charles and I talked about this before he took the job on. He's been, his company, AMS, of which he cofounded, he was chairman of the board and CEO prior to being named head of the Internal Revenue Service. He's a graduate of Georgetown University and has a MBA from Harvard, and he was a former Pentagon wiz kid. But most of all with his company, AMS, which is headquartered in Fairfax, VA, he understands information technology. He understands the changing role of technology, and he understands how you treat customers, which is something the IRS has not had a great historic track record for anything that they can brag about.

I've read his testimony today and I'm very impressed with the direction the Service is going at this point. I think sometimes there comes a man for the times, and when it's a difficult time, a transitional time, this is what it is for the Internal Revenue Service, and I think not only with Mr. Rossotti's business background and his success there, his understanding of information technology and its changing roles as we deal with the computer systems at IRS, Y2K problems and other priorities, his understanding of the needs of the customer, but most of all his integrity that he has shown with a long distinguished career in business. He has been universally regarded as a pillar of integrity in the business. This is the man to lead the IRS in a very difficult time.

So I'm very proud to have him as a corporate constituent in Fairfax, even though he technically lives in the District of Columbia, and also in the part of the job he is doing and look forward to hearing from him today.

Mr. HORN. I thank the gentleman. Commissioner, we have a routine in subcommittees of Government Reform and Oversight. If you and Mr. Musick will stand and raise your right hands.

[Witnesses sworn.]

Mr. HORN. The clerk will note that both gentleman have affirmed the oath.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, I just note that I had to swear to the IRS yesterday as I signed my returns so it's kind of turnabout here.

Mr. HORN. Gee, I'm surprised by that. Commissioner, it's all yours. We're delighted to have you.

STATEMENT OF CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY ANTHONY MUSICK, FORMER CHIEF FINANCIAL OFFICER, INTERNAL REVENUE SERVICE, CURRENT DEPUTY CHIEF FINANCIAL OFFICER, DEPARTMENT OF COMMERCE

Mr. ROSSOTTI. Mr. Chairman, thank you, and Congressman Davis, thank you for that introduction. Every time I hear these kind words, it makes me lose even more sleep because I worry if I can live up to this. But we hope 2 years from now, after the turn of the year 2000, that we'll still be back here and beginning with those kind of comments. I do welcome the opportunity to testify and speak also with respect to the GAO audit of our 1997 custodial financial statements.

Since I became Commissioner, I have tried to make clear my priorities for the IRS which are to shift the entire focus of the agency from one which focuses solely on conducting our own internal operations, to one which puts far more emphasis on trying to see things from the point of view of taxpayers, emphasizing service and fairness to taxpayers. I would like to just very briefly lay out first my concept of how we have to go about modernizing the IRS in order to achieve these kinds of goals.

Let me say, though, at the outset that the restructuring legislation which is currently before the Senate is extremely important to our ability to carry out some of the changes that I think we need to do, and in particular, some of the increased flexibility in the personnel area.

I think that one of the important things I'm going to mention that we need to do is to streamline the roles and responsibilities of managers in the IRS, and we're going to have to enrich the existing internal executive group with some selective hiring from the outside. The legislation will be very important enabling us to do that.

I've outlined five basic areas where we need to modernize the IRS, and I think all five of them go together and are important. The first one is to really rethink all of the business practices that we conduct at the IRS, so that we can shift the focus toward understanding, solving, and maybe preventing taxpayer problems much earlier in the cycle so they don't get far downstream and cause severe problems for taxpayers very late in the process.

Part of this is to look at the particular problems of particular groups of taxpayers that have common needs. It's a big country. There is a lot of different kinds of taxpayers, and if you look at college students, senior citizens, and small businesses, they're very, very different, and we need to tailor our practices to serve each kind of customer.

Second, we do need to rethink the organization's structure so that we can have clearer responsibility for serving each of these segments of taxpayers. I think one of the things that we need to do there is to reorganize so that each unit has end to end, as I call it, full responsibility for serving a segment of taxpayers such as small businesses.

The third thing is we do need to streamline internally and to create fewer layers of management and to define management roles with much clearer responsibility and accountability.

The fourth area is in measuring organizational performance so that we get what we really want, and we measure what we really want, and balancing customer satisfaction, business results, employee satisfaction, and end productivity. It is important that our employees be measured by what we actually want them to do, and a big part of that is serving taxpayers helpfully and productively.

And of course the fifth and really huge area is technology. IRS' current computer systems simply cannot support the agency's mission and goals. We really very much need to upgrade our 20- and 30-year-old computer systems. Building systems, of course, to support the old business practices and the old organization will not work either. So the organizational changes and the technology changes go hand and hand.

I'm pleased to say that the recently issued technology modernization blueprint and some of the changes that have been made within the CIO organization, do provide the beginning of a basis for managing our new technology.

Mr. Chairman, we have engaged the consulting firm of Booz-Allen & Hamilton to help us validate these changes, especially the organizational changes, and to define in more detail the risks, the costs, and the impacts. We will be reporting in more detail when that study is complete, hopefully this summer.

I think that the restructuring legislation and the changes that I have proposed to make it work provide a compelling case that the President's fiscal year 1999 budget, as requested, be approved. This will enable us to make a start on improving customer service and technology, as well as provide an initial $25 million to begin the modernization of the organization.

And, of course, Mr. Chairman, before any of these improvements can really be realized, we absolutely must deal successfully with the century date change problem, so that our computer systems can continue to operate successfully after the turn of the century.

Now, let me just turn briefly to the financial audit. I must say that, not with any help from me, because I was not even here for most of the time when this work was done, but nevertheless I'm very happy that, as you mentioned in your introduction, the IRS did receive from GAO an unqualified opinion on the 1997 fiscal year custodial financial statements. I'm also pleased to report that the Treasury Inspector General gave a similar clean opinion on the 1997 administrative financial statements.

I think that this success does reflect the commitment of the organization to Congress and specifically to the subcommittee to improve financial management in the IRS and to hold ourselves to the same standards expected of taxpayers. As GAO has indicated, however, and I must say I agree with this, this excellent result was achieved because of a very special effort on the part of the IRS financial staff and operating staff, not because we have the basic systems that we need to really support modern financial management in our tax system. This is one of the reasons why we do need to not fall through on the modernization blueprint.

I will confine myself to those general comments, Mr. Chairman, on the financial statements because I have had to recuse myself from detailed involvement with this matter because of a potential conflict of interest with my former company. So I will leave my colleague, Mr. Musick, who is actually the one who did all the work anyhow to comment further on the financial statement matter.

In conclusion, let me just say that although budget dollars are essential, money alone is not going to solve the problems of the IRS. We're going to have to follow through on a comprehensive modernization plan, which includes organizational and technological modernization, as I've indicated. I do believe, though, that there is a new day at the IRS in the sense that we are opening a new part of the history of the organization, and each day we push forward the process of change a little further. The restructuring legislation and the other support that we're getting from Congress will very much help us with this.

Thank you very much Mr. Chairman.

[The prepared statement of Mr. Rossotti follows:]

STATEMENT OF CHARLES O. ROSSOTTI,
COMMISSIONER OF INTERNAL REVENUE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
HOUSE GOVERNMENT REFORM AND OVERSIGHT COMMITTEE
APRIL 15, 1998

Mr. Chairman and Distinguished Members of the Subcommittee:

I welcome this opportunity to examine organization and management options for the IRS and to report on the results of the General Accounting Office (GAO) audit of IRS' fiscal year 1997 custodial financial statements.

MODERNIZING THE IRS

Since I became IRS Commissioner, I have made clear my priorities for the agency. I have heeded the call to action sounded by both taxpayers and the Congress to modernize the IRS and shift its focus to service and fairness to taxpayers. I want to lay out briefly my concept of IRS modernization.

Mr. Chairman, let me say from the outset that enactment of restructuring legislation with increased flexibilities in personnel is critical to the strategic vision I am about to describe. If we are to maximize our efforts to transform the IRS into an efficient, modern and responsive agency, I must have the ability to recruit and retain a top-notch leadership and technical team.

Five Key Elements

We will reach our goals of service to each and all taxpayers through changes in five key areas, each complementing the other. These five areas, along with the goals and guiding principles are summarized in Chart C. I will give a brief summary of the five key elements.

I. Revamped IRS Business Practices That Will Focus on Understanding, Solving and Preventing Taxpayer Problems

Each of the IRS' business practices, from customer education to filing assistance to collection, holds great promise for improvement. We must better understand taxpayers' particular problems and continuously focus on solving them. In most cases, there are close parallels in the private sector upon which we can draw.

Just as companies develop specific marketing programs to meet customers with specific needs, so must we adapt our services to conform to the needs of particular groups of taxpayers. Instead of the historic "one size fits all" agency, we should tailor publications, education, communications and assistance programs to taxpayer groups with certain needs. College students and seniors are but two examples. This should dramatically improve service to taxpayers as well as our internal productivity.

The IRS can also take a cue from the private sector when additional money may be due and collection activity is required. And that cue is early intervention. Unfortunately, more often than not, the agency reacts to rather than anticipates problems. Today, 90 percent of the active IRS collection activity is on accounts more than six-months old.

This is the reverse of private sector practices. There are two proven keys to effective collection. First, identify as promptly as possible customers who may present a risk of non-payment. And second, work out a payment program that addresses the individual problem of the customer. The rewards are two-fold. This early intervention helps both the customer and the collecting agency, and minimizes the need for enforcement actions.

II. Organizational Structure Built Around Taxpayer Needs

The present IRS structure does not allow its managers to know about and take action on major taxpayer problems. Its structure also inhibits modernizing business practices and technology needed to achieve our goals. The principal IRS organization, as shown in Chart A, is built around 33 districts and 10 service centers. The mission of each of these 43 units is to serve every kind of taxpayer, large and small, with simple or complex problems. Mr. Chairman, the present structure is much too complex, and accountability is far too weak.

Once again, I believe we can import sensible organizational practices from the private sector to better serve our customers, the American taxpayers. As shown in Chart B, one potential way to organize the IRS is to divide it into four units, each charged with top-to-bottom responsibility for serving a group of taxpayers with similar needs.

The four units could be: (1) the 100 million filers made up of the approximately 140 million taxpayers, who have only wage and investment income; (2) small businesses, including sole proprietors and small business corporations; (3) larger businesses; and (4) the tax exempt sector, including employee plans, exempt organizations and state and local governments.

These units could replace the IRS' four regional offices and a substantial part of the national office. This would free up the national office to devote its time and resources to its primary mission of oversight and broad policy.

III. Management Roles with Clear Responsibility

Under the structure I just described, the management teams for each of these units will become experts on the needs and particular problems of their customers. And they will be held fully accountable for achieving specific goals in serving them.

I am also describing a much flatter and leaner IRS with fewer layers of management. Through this streamlining process, front-line employees and first-line managers will more closely identify and communicate better with those with general management responsibility.

For each unit, a cohesive management team will be assembled that will organize itself in ways that fit the needs of the taxpayers they are serving. I believe that highly qualified managers, from both within the IRS and from the private sector, will be attracted to these kinds of hands-on management jobs.

IV. Balanced Measures of Performance

It is essential to have measures of organizational performance that balance customer satisfaction, business results, employee satisfaction and productivity. As the National Commission on Restructuring the Internal Revenue Service rightly observed, it is important to develop a measurement system that influences employee behavior in a positive way. We should create a system that does not directly or indirectly cause inappropriate behavior toward taxpayers, but rather one that fosters customer service.

Mr. Chairman, the establishment of management teams with clear responsibility for serving the four groups of taxpayers will for the first time help make it possible to develop realistic and meaningful measures of organizational performance in the areas of customer satisfaction and overall compliance. They will help eliminate the problem that has plagued the IRS for decades, namely the use of "enforcement" results as a key measure of success.

All IRS measures of performance are being reviewed in light of our goal of transforming the IRS from an internally focused organization to one which views itself from the taxpayer's perspective and eliminates the use of all enforcement statistics for measuring organizational performance. We have a task force working on this problem, and we expect to engage expert outside consultants to assist in this task. We expect to have interim results to use for measuring performance during the next fiscal year. These measures will build on some of the measures included in our FY 1999 budget submission.

V. New Technology

It is clear that IRS' computer systems cannot support the agency's mission and goals. They are a major impediment to our ability to modernize business practices. But while new technology is desperately needed at the agency, we must be cautious. Building new computer systems to support old business practices and a complex organizational structure will simply not work.

The Restructuring Commission concluded that information technology should be used to enable the IRS to achieve its strategic objectives, not to drive them. I fully concur. The technology modernization blueprint and the new Chief Information Officer organization provide an excellent basis for managing our new technology. The revamped business practices and the new organizational structure I described will also lay the foundation for completing and implementing the modern systems envisioned in the blueprint.

RESTRUCTURING LEGISLATION

IRS reform legislation in the Senate is consistent with the organizational modernization that I have proposed, especially in the fundamental shift towards improved service and fairness for taxpayers. I believe that any proposed legislation should be seen within that context. Some of the taxpayer bill of rights provisions will also require significant changes to computer systems. As the Senate moves toward floor action and in the potential conference that will follow, it is important that we work together to develop effective dates for these provisions that are feasible in light of Century Date Change and other tax law requirements.

Assuming that workable dates can be developed, we should be able to make the proposed changes within the limits of the FY 99 budget as now submitted. The restructuring legislation does, however, make an even more compelling case that the FY 1999 IRS budget amounts requested be approved for technology and customer service improvements, as well as for the $25 million for organization modernization.

FINANCIAL MANAGEMENT

For the first time since the Chief Financial Officers Act became law in 1990, GAO has given an unqualified — or "clean" — opinion on the reliability of the IRS' Fiscal Year 1997 custodial financial statements. I am also pleased to report that the Treasury Inspector General has given a "clean" opinion on our FY 1997 administrative financial statements. Our former Chief Financial Officer, Anthony Musick, will discuss the audits in detail.

CONCLUSION

In a broader sense, although budget dollars are essential, money alone will not solve the problems facing the IRS. These challenges will be solved by revamping the business structure, realigning the organizational structure, redefining management's roles and responsibilities, creating balanced measures of performance, and investing in technology that supports a modernized IRS.

Mr. Chairman, on numerous occasions, I have said there is a new day at the IRS. And with each day, we push the process of change ahead even further. With the help of the Congress and the restructuring legislation we will reach our goals.

Chart A

IRS Organization Today *(Simplified)*

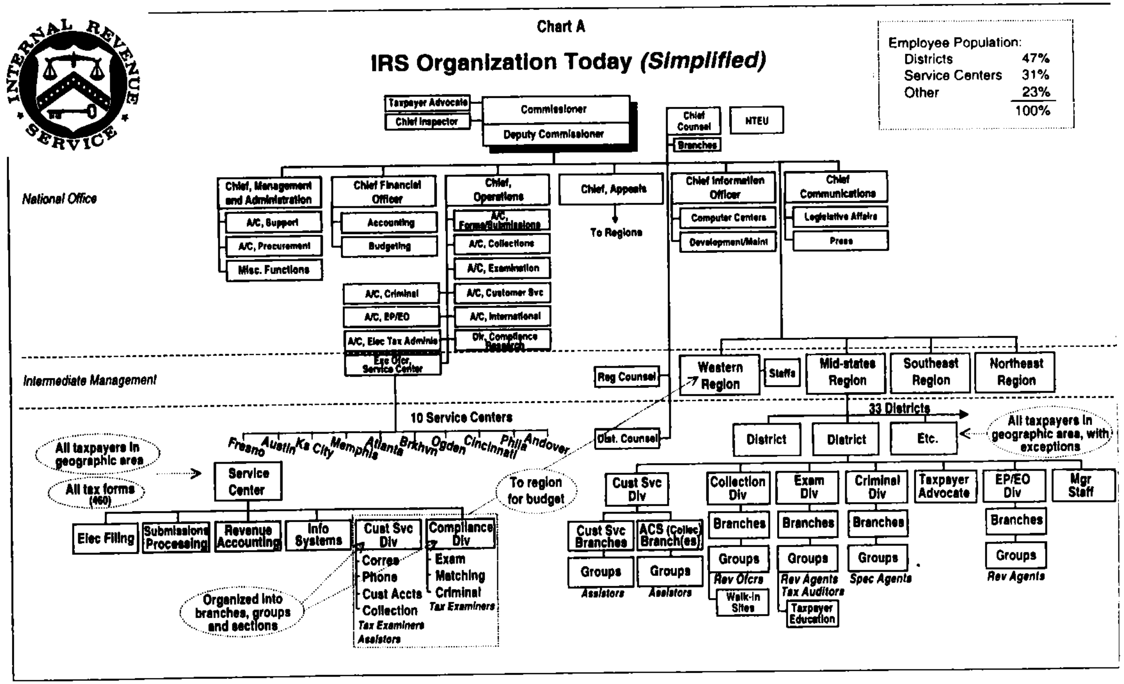
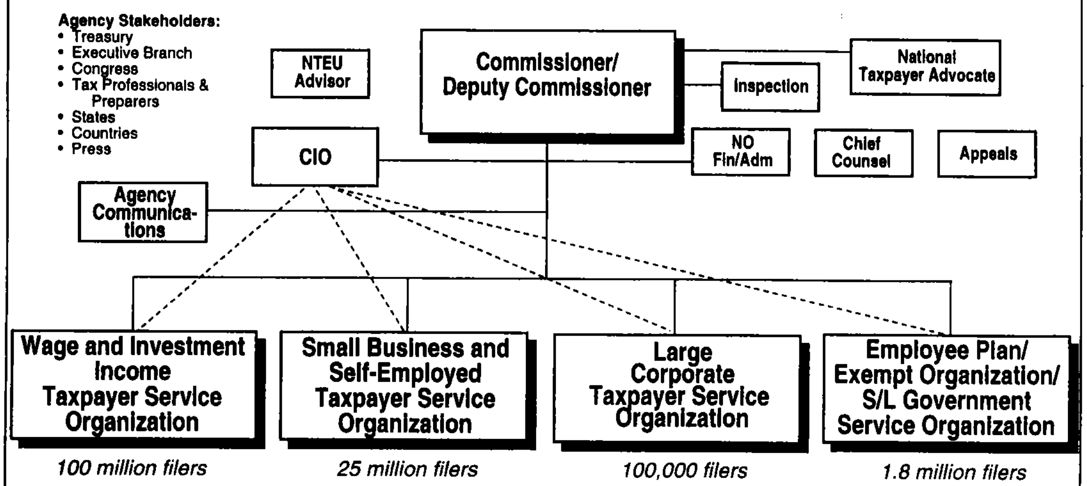


Chart B

Top Level Organization Concept



All line operations conducted by 4 major operating units, each serving a major group of taxpayers with like needs. These replace 4 regions and part of NO. Technology management is centralized, but each operating unit is the business owner for systems that support it. NO becomes much smaller corporate headquarters. Each operating unit is internally organized differently, tailored to specific needs of its market.

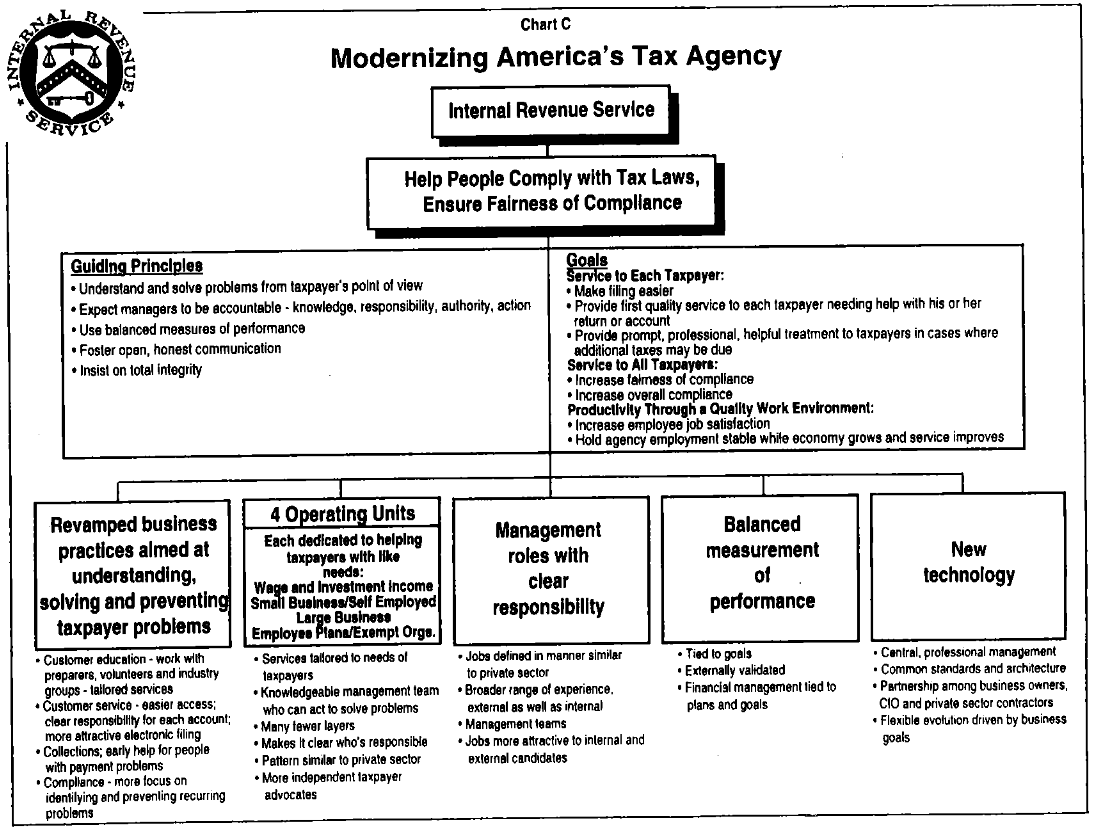


Chart C
Modernizing America's Tax Agency
Internal Revenue Service
Help People Comply with Tax Laws, Ensure Fairness of Compliance
Guiding Principles
• Understand and solve problems from taxpayer's point of view
• Expect managers to be accountable - knowledge, responsibility, authority, action
• Use balanced measures of performance
• Foster open, honest communication
• Insist on total integrity
Goals
Service to Each Taxpayer:
• Make filing easier
• Provide first quality service to each taxpayer needing help with his or her return or account
• Provide prompt, professional, helpful treatment to taxpayers in cases where additional taxes may be due
Service to All Taxpayers:
• Increase fairness of compliance
• Increase overall compliance
Productivity Through a Quality Work Environment:
• Increase employee job satisfaction
• Hold agency employment stable while economy grows and service improves
Revamped business practices aimed at understanding, solving and preventing taxpayer problems
• Customer education - work with preparers, volunteers and industry groups - tailored services
• Customer service - easier access; clear responsibility for each account; more attractive electronic filing
• Collections; early help for people with payment problems
• Compliance - more focus on identifying and preventing recurring problems
4 Operating Units
Each dedicated to helping taxpayers with like needs:
Wage and Investment Income
Small Business/Self Employed
Large Business
Employee Plans/Exempt Orgs.
• Services tailored to needs of taxpayers
• Knowledgeable management team who can act to solve problems
• Many fewer layers
• Makes it clear who's responsible
• Pattern similar to private sector
• More independent taxpayer advocates
Management roles with clear responsibility
• Jobs defined in manner similar to private sector
• Broader range of experience, external as well as internal
• Management teams
• Jobs more attractive to internal and external candidates
Balanced measurement of performance
• Tied to goals
• Externally validated
• Financial management tied to plans and goals
New technology
• Central, professional management
• Common standards and architecture
• Partnership among business owners, CIO and private sector contractors
• Flexible evolution driven by business goals

Mr. HORN. We thank you, and now, Mr. Musick, if you can summarize your statement, we'll then open it for questions.

Mr. MUSICK. Thank you, Mr. Chairman. Mr. Rossotti covered a number of points that I won't, but I think it's important to reiterate that this is the first time that the organization has received the clean opinion or unqualified opinion from both the Inspector General and the General Accounting Office on both our statements. We do have two sets of statements: One administrative, which controls our appropriated funds, and the other which controls our custodial funds, and that's the tax revenues we collect. However, I would also like to add to what Mr. Rossotti said that receiving an unqualified opinion does not resolve some of the serious technology problems related to tax systems. These problems need to be thoroughly addressed if we're to continue making critical important financial management in-roads.

There are two weaknesses that the GAO identified that I think need to be highlighted. As the GAO indicated in its audit report, the IRS general ledger does not support the preparation of custodial financial statements, and the revenue systems lack a subsidiary ledger for unpaid assessments. What this means is that the IRS will have to continue to extract detailed data from the taxpayer master file and reconcile it to its old accounting system so that the auditors can continue to express an opinion on the reliability of the numbers. This is not the most effective or efficient way to develop financial statements for such a large organization, but given the existing technology, I'm not aware of another choice.

I'd also like to point out that this problem does not exist with the administrative systems. Over the last few years, we have implemented a corporate financial system eliminating 8 stand-alone accounting systems, and by the end of this October it will be year 2000 compliant. So we feel very comfortable on the administrative side that we can continue the success.

I believe that the clean opinions by the GAO and the Inspector General do not mean that the IRS financial management objectives have been accomplished. They are just beginning. The problems we have been addressing took years to occur; therefore, they can't be fixed quickly or overnight. However, I do believe that the management attention and resources are being applied to build upon the current results, and that financial management in the IRS will be a model in government.

Thank you, Mr. Chairman. This concludes my remarks.

[The prepared statement of Mr. Musick follows:]

STATEMENT OF ANTHONY MUSICK
FORMER IRS CHIEF FINANCIAL OFFICER
BEFORE THE
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY
HOUSE GOVERNMENT REFORM AND OVERSIGHT COMMITTEE

APRIL 15, 1998

Mr. Chairman and Distinguished Members of the Subcommittee:

I am pleased to be here today to discuss the progress the Internal Revenue Service (IRS) has made in improving financial management. For the first time since the Chief Financial Officers Act became law in 1990, the IRS received an "unqualified" or clean opinion from the General Accounting Office (GAO) audit of the Custodial Financial Statements for Fiscal Year 1997. GAO could determine the reliability of $1.6 trillion in revenue collected and $28 billion in accounts receivable.

The GAO Custodial audit was just one of the financial audits being conducted in Fiscal Year 1997. It is important to keep in mind that the Service has two sets of financial statements: (1) custodial and (2) administrative and two separate financial processes to track funds: the revenue system tracks tax collections and the administrative system handles our appropriated funds.

I am also pleased to report to you that the Treasury Inspector General (IG) has issued a separate report on our Administrative Financial Statements for Fiscal Year 1997 and again, for the first time, the Service received an "unqualified" or clean opinion on those statements. By issuing this opinion the IG could validate the financial position and results of operations related to the IRS' $8 billion in appropriated funds and reimbursements and the over $1.7 billion in total assets.

This has been a massive and extraordinary effort by IRS employees, GAO and Treasury IG auditors. The success reflects our commitment to the Congress, and specifically to this Subcommittee, to improve the IRS' financial management and to hold ourselves to the same standards for record keeping expected of taxpayers. In spite of the clean opinion, however, I must add a strong note of caution. Receiving an unqualified opinion does not resolve some of the underlying problems. The opinions are the beginning not the end of our efforts to improve financial management. Serious technology problems still exist at the IRS and need to be thoroughly addressed if we expect to continue to make critically important financial management inroads.

Financial Challenges Continue to Exist with Custodial Accounts

In its audit report, GAO cited six material weaknesses in IRS internal controls and credited IRS with previously identifying these weaknesses in its annual Federal Managers' Financial Integrity Act report and we are taking action to correct them.

Two of the weaknesses identified by GAO represent a significant challenge to the Service and will take years to fix. As the GAO indicated in its audit report, the IRS' General Ledger does not support the preparation of financial statements and the revenue system lacks a subsidiary ledger for unpaid assessments. The custodial general ledger system – the Revenue Accounting Control System (RACS) – was not designed to meet the requirements for audited financial statements. It was designed to ensure that cash is deposited in the bank and that transactions are properly posted to a taxpayer's account.

RACS does not use the Standard General Ledger nor does it capture or otherwise produce information to be reported in the financial statements; it does not classify revenue receipts by type of tax at the detail transaction level; it does not provide a complete audit trail for recorded transactions; and the accounts receivable system does not have a detailed listing (or subsidiary ledger) which tracks and accumulates unpaid assessments (taxes due from taxpayers, compliance assessments, and write-offs) on an ongoing basis.

These basic problems will take several years to correct, possibly hurting in the short term some of the progress we have made. However, we have worked closely in the development of the Modernization Blueprint to ensure that these problems and other financial requirements are being addressed.

We have also made significant progress on a third weakness, computer security, which GAO brought to our attention in earlier reports. We have centralized the responsibility for security and privacy within the Office of Systems Standards and Evaluation (SSE) and have brought together an experience-based team to actively manage computer security improvements at all our facilities. The SSE is also using contractor support in areas where even more specialized skills can help the IRS to institutionalize "best practices." For example, SSE is working with a contractor to enhance the IRS' emergency response capabilities, which include state-of-the-art practices to better recognize and prevent hostile attacks.

In 1997, SSE did a base-line measure of computing and service centers. It also worked with managers and staff of the centers and support functions to develop plans for implementing security improvements. Approximately 40 percent of the identified problems have already been corrected.

Since these managers and staff are key to making the necessary security improvements, SSE has initiated security-training efforts to enhance the skill mixes needed at the centers and support functions. For 1998, training and work will continue at these centers and support functions. Our target is to have computer security corrective actions completed by June, 1999. In terms of broadening the SSE agenda, work began this year on base-lining the security operations of IRS' 33 District Offices. An action plan to implement District Office security improvements will follow.

The fourth weakness deals with the lack of controls over refunds. We have taken significant steps to improve our controls, such as: 1) reviewing all local controls over manual refunds; 2) implementing additional system approaches for early fraud identification for paper and electronic refunds; 3) creating an Electronic Filing Fraud Control group; and 4) testing for false claims.

The fifth weakness involves supporting documentation for unpaid assessments. We hired a contractor to conduct a study on IRS documentation practices; a draft report is being reviewed in conjunction with this year's audit findings.

The final material weakness concerns the IRS' inability to determine specific amounts of revenue actually collected for the Social Security, Highway and other relevant trust funds. The accounting information needed to make these determinations is not provided at the time the taxpayer remits payment -- that is, the taxpayer is not required to provide payment breakdown by trust fund. In order to accomplish this goal, changes in the Internal Revenue Code would have to be made. The IRS believes that this is a taxpayer burden issue, not just an accounting issue. We have taken steps to accommodate such information, if and when it is mandated, or if the taxpayer chooses to provide the information.

Significant Improvements in Administrative Accounting

We are very proud of the significant improvements we have made in our administrative accounting system. Just six years ago, we had eight separate systems that were not linked to each other. Now we have a single corporate data base for our appropriated funds. This system provides an integrated, auditable, comprehensive accounting and budgeting system that fully complies with the government standards, including the Standard General Ledger. it collects, processes, maintains, transmits, and reports data about financial events; supports financial planning and budgeting activities; accumulates and reports cost information; and supports the preparation of financial statements. Additionally, we are taking steps to have the year 2000 issue resolved by October 1, 1998.

Unlike the revenue statement findings, the five IG findings are more procedural or process related and I believe they can be resolved in the near future. These relate to improving controls over property and equipment, improving year end procedures for accounts payable, improving procedures to identify transactions to be eliminated in the Department of Treasury consolidated financial statements, improving controls over reimbursable accounts receivable and strengthening data processing general controls.

Actions are being taken to resolve all of these; however, because of our size it may take more than one more reporting period.

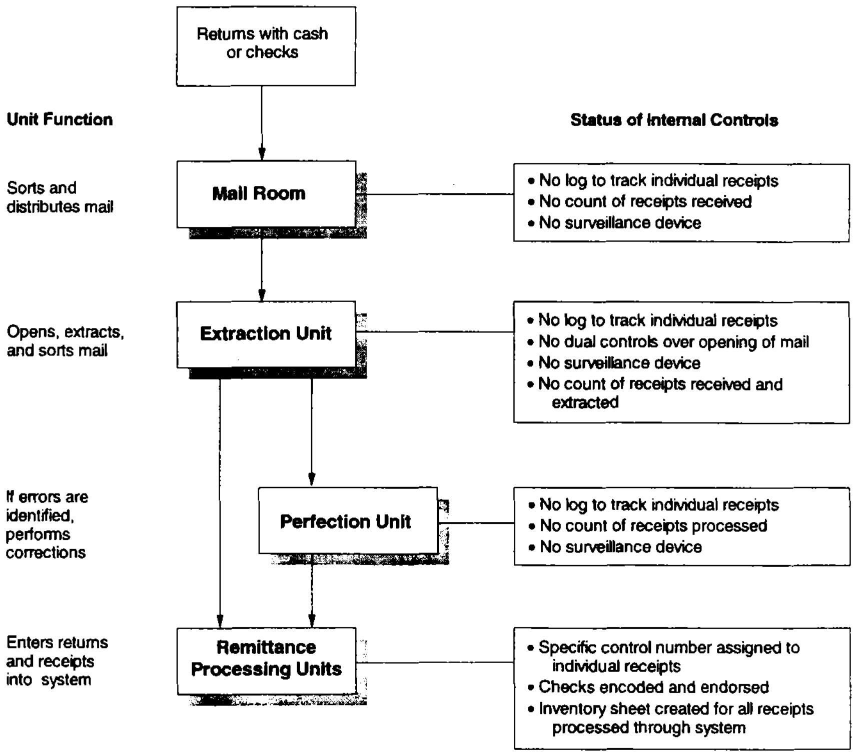
Conclusion

I have tried to describe to you the priority and significance that we have attached to our financial management responsibilities and the progress we have made. As I stated earlier, I believe that the clean opinions given by the GAO and the IG do not mean that our financial management objectives have been accomplished. In fact, our work is just beginning.

The problems we have been addressing took years to occur and cannot be fixed quickly. The revenue system will take several years to fix; however, we must also address the processes and the accounting issues related to revenue.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions.

Initial Handling of Service Center Mail



Mr. HORN. Well, we thank you.

We will now start the questioning. There will be 10 minutes alternating between each side. The gentleman can be with us, can you, for the next half hour?

Mr. DAVIS OF VIRGINIA. About 15 minutes.

Mr. HORN. OK, we'll get there.

Let me start, Commissioner, with a couple of broad policy questions. One that interests me is the collection strategy. I've noticed with interest that you have, and GAO, the General Accounting Office, also has fairly good analysis of what is the possible write-off, what is possibly collectible, and so forth.

Could you tell us a little bit about how you feel about where we are with the IRS in collecting the money in a timely way so that the rest of us that pay our taxes don't have to be making up for the defaulters and the deadbeats. So what kind of strategy do you have in mind?

Mr. ROSSOTTI. Well, Mr. Musick said he was able to get a clean opinion on the financial statements, the custodial financial statements, by essentially being very ingenuous in working with some old systems and figuring out a way to get around the limitations of these, and ultimately got a result which GAO felt was reliable, but which was really not an appropriate long-term way to do business.

I would say the same thing about the way that we collect money. There is a very great opportunity within the IRS using emulation of practices in the private sector, I think, to collect money, and now here I'm talking about collecting money where the debt is already established, not the question of examinations of returns or examination of potential issues about how much tax liability there is.

I'm saying given that there is a tax liability established, the amount of collecting it, the most basic and most important observation that I have come across since I've been at the IRS is just simply the age of the receivables that we collect. In other words, if you look at all the collection activity that the IRS does with its phone collectors and its field collectors, 90 percent of that effort is applied to accounts that are more than 6 months old, and many of them are many years old. That's the reverse of what anybody in the private sector would do.

I mean they would put all their effort on finding out where the risks are up front and getting into those as quickly as possible and only as one of a specialized kind of an effort would be applied downstream.

Now why is that? Well, that gets to the basic questions of—it's very analogous to issues about the financial statement. It's not a simple problem to fix because it's embedded in the organization structure, the business practices, in some cases regulations, and most importantly, the computer technology.

I mean if you look at the IRS collection apparatus, broadly speaking, there are three different kinds of collection operations, each with its own different computer system, and its own data base spread over 43 different operational units, and each of those is charged with collecting from every kind of taxpayer from small to big but over every kind of taxpayer, and it's possible that any one taxpayer could be involved with at least three or four of these different units.

Now, it isn't because some evil person sat down and said let's design an overly complex system. It just evolved like Topsy over 45 years and each place was put in. I think there are some improvements we can make in the short term, which we're attempting to do, but I think that the real answer here lies in modernizing and rethinking the whole thing, and really just trying to do it in a way that is more similar to what the private world does.

Mr. HORN. On that point, let me ask you what is your perception at this point of what the IRS should do and what private collectors should do? Now, I'd heard in the past from some of your predecessors that, oh, gee, there is a privacy problem. I don't see the privacy problem; just give them the address, and give them what the person owes. If they have got a bone to pick with the IRS, fine. Then let the IRS deal with that. But it seems to me the failure has been, and what started us on our debt collection bill, which is now law, but the Ways and Means Committee has not yet applied it to IRS, is that they had the $64 billion possible collectible, $110 billion written off that they had just given up on, and I just think if we can nip this in the bud, and I realize some are bankruptcy cases and this kind of thing, that we would be way ahead of the game in terms of what the rest of us are doing.

Mr. ROSSOTTI. Well, there is no doubt that there is opportunity, and there may well be opportunities to work with the private sector in a lot of respects on that and other matters. I do think, though, that the graft to graft as was attempted in a pilot—to sort of graft a private sector debt collection onto what we have got now—is only going to frustrate the private sector as well as the public sector. I mean, we really have to rethink the whole process.

Unfortunately, it's not as simple a problem as we might like it to be. I do believe, although, I mean I guess I'm an optimist or I wouldn't be here, but I think the way to look at it is that there is a great deal of opportunity to improve the entire process if we can rethink it from top to bottom, and in that process there may well be opportunities simply to work with the private sector on certain aspects of this. But to just do it now as was shown is probably just going to frustrate everybody.

Mr. HORN. Well, the pilot, one of them was just so phony it was unbelievable. They gave 5-year-old debt hoping it would fail, and that bothered me about that administration of the IRS. And you're a fresh broom around there; you can make some choices. It would seem to me as a former executive myself, you can put your own organization on it for the first 15–30 days, get the letters out, so forth, see what happens, but then we should move beyond that, and I would hope you take a very careful look at that.

Allocation of trust funds. One of the things that's concerned me over the years is when the trust funds come in on the highways, on the Social Security, on Medicare, they really sort of sit around, and they don't get allocated specifically to a trust fund until a formula is applied sometimes weeks or months later. Have you had a chance to look at that question?

Mr. ROSSOTTI. Only generally. I think I'm going to ask Mr. Musick to answer that one.

Mr. MUSICK. OK. One of the problems we have with that is the way the paper-based systems were built, and it was based on a coupon where the taxpayer would submit one payment, and there are probably some 100 trust funds, but on that coupon you can fill in a blank that says 720 and submit your payment. Really you can't tell how to allocate that until the return comes in later.

Now, what is being done to address that are a couple of things. The systems that are currently being built at the CFOs organization have been working in the modernization plan to have detailed transactions in those systems. The problem is that until IRS gets a general ledger that will accept detailed transactions, you still need to post them at a summary level. So that's being addressed.

The other issue is for those people who would continue to be on a paper-based system, is there a tax or not a tax, but is there a burden issue with them to break that out and provide it. Basically, what they would have to do is submit the 720 return every time they sent in a payment to show where the differences were between the trust fund payments.

Mr. HORN. What would you consider, Commissioner, the major problem besides the reorganization, the attitude change, and all the rest? What do you see as your major problem?

Mr. ROSSOTTI. Well, of course, there are different priorities at different times. I'd say that without a doubt the most unfortunate, but most essential problem that we simply have to deal with is simply converting year 2000 to make it work, because if that doesn't happen none of the other things we're talking about are going to mean anything.

I mean we simply will not be able to continue to function, and the consequences of not dealing with this appropriately are really not exaggerated; they really are quite severe. I mean we could be in a situation where you wouldn't be able to get refunds out, you wouldn't be able to collect money. We just can't allow that to happen.

Now, unfortunately, in the case of the IRS, this is a massive problem that is compounded by the age of the systems that we have to renovate. You know, I just saw in one of the trade magazines that General Motors reported to the SEC that, as they are required to do, they estimate $360- to $500 million to deal with their year 2000 problem for General Motors.

Well, that's about half, perhaps less than half of what we're dealing with, and I can assure you that, because I know some of the people there, General Motors has a much deeper bench of experienced managers in technology than we do. We have some very good ones, but we have a thin one. So I have to say that I am personally giving my own personal top priority to working with the people, who are working with this problem, and that is an unexpected, but very challenging short-term problem. I think putting it in sequence as a short-term, the next most important thing is to deliver some improved short term service improvements to the taxpayers because they just expect it, and we are doing this in this filing season.

I mean electronic filing is up 25 percent, and we have much better phone service than we had previously, and we've improved some of the ability of taxpayers to get personal help when they need it on particular problems through open houses and that sort of thing. So there is a whole laundry list of things like that that we're doing short term. None of that is really going to solve these problems, and you've identified two of them. One is debt collection, and the other is financial statements just in this hearing, both of which get to the root of fundamental organizational processes. So that's why we have to upgrade the technology and modernize the organization.

Mr. HORN. On the year 2000 situation, I know you have a whole series of different machinery—hardware—over there. How optimistic are you that you can get the basic work done so it's operational, let's say, by mid 1999? Is that where the target is now or what?

Mr. ROSSOTTI. Actually, our target is January 1999. Our target is to have—because the way it works with filing seasons, we really have to get most of our tax-sensitive systems upgraded, either replaced or renovated in most cases by January 1999. That is our goal, and there is a whole list of different categories. On some of the areas, some of the most critical areas actually were in quite good shape on the application programs themselves, which are the actual ones that contain the logic. Those are in pretty good shape.

I think where we have the most risk is really in two areas. One is in our telecommunication network, which unfortunately is very diverse and not very well integrated network, and the other one is in some of these minicomputers, what they call the Tier II platforms of which we have about 54 different varieties. Those are going to be complex primarily from the point of view of testing. We have the right software to make it work, but the testing process is going to be a problem.

So I think those are the two that we're concentrating most effort on right now.

Mr. HORN. Thank you. We'll get back to some of the computer questions a little later. I now yield 10 minutes to the gentleman from Ohio, the ranking Democrat on the committee, Mr. Kucinich.

Mr. KUCINICH. Thank you very much, Chairman Horn, and thank you for calling this hearing today. This is truly a day when we celebrate the long-suffering American taxpayer, and you can imagine what a fantasy it is to be up here having a chance to question the IRS. I mean I'm sure that the Members here are the envy of millions of Americans who would like this opportunity particularly today.

So on behalf of those millions of Americans who would like this opportunity, I have some questions for you, Mr. Rossotti, and I appreciate you being here. I know what a busy day this is for you, and when you think that this is an agency that processes over 200 million tax returns and reviews more than 2 billion documents, if I'm correct, collect over $1.5 trillion in revenue, and if I'm correct, 52 million refunds of which totals about $72 billion for this tax year have already been issued; is that correct?

Mr. ROSSOTTI. That's right.

Mr. KUCINICH. So you have been pretty busy, particularly with the technology that dates back to the seventies—some in the sixties, and I think that toll-free line that you have, it's about 26 million calls that you've answered for the 1998 filing seasons.

Mr. ROSSOTTI. Already. Um-hum.

Mr. KUCINICH. So we have an Internal Revenue Service and we have to recognize it handles a tremendous amount of work, 25 million returns, I think, in the last 3 days. So we can well understand the complexities that you have to deal with, and you, I'm sure, can understand the concerns that we Members of Congress have, to make sure that our constituents believe that they are being treated fairly, with respect, and given the information they need in order to comply with the Tax Code.

Now, Commissioner, in the Washington Post this weekend we read about how the IRS pursued a man to collect a second tax payment of $2,600 even though the man had a canceled check to prove that he had already paid the $2,600 in taxes. I think you're probably familiar with this story, and in recent months we have heard about taxpayers receiving notices for millions of dollars in tax liability and taxes applied to the wrong accounts.

The GAO identified three cases in which the IRS pursued taxpayers for additional taxes after they had already paid because the IRS lacked accurate data. Now, how do these kinds of mistakes occur? And what do you do to rectify some of these matters and to prevent reoccurrences? I think the people would be interested, particularly those people who right now at this moment may be watching and saying, you know, I have kind of a problem, and what do I do about it?

Mr. ROSSOTTI. Well, first, let me just say with the example of the gentleman who sent in his canceled check still that wasn't good enough. I mean there are some things that we just have to basically rely on and move toward a changing point of view at the IRS, let's say, attitude, because I think some mistakes will always happen given this volume of information.

I mean, this can happen even in your private credit card business. You'll have a check that doesn't—I mean that case of that check was actually two separate banks that made an error, which will happen given the billions of transactions. I think the important thing, though, from the point of view of what we need to do about it for the taxpayer is that we should not be attempting to fold that burden back on the taxpayer. In fact, our procedures do say that if a taxpayer sends in proof of payment like a canceled check, it should be incumbent upon the IRS people to take ownership of that problem as with any other kinds of problems and fix it.

So I think at sort of a root level, the answer to your question is we need to become more of a—think of ourselves more as problem solvers that if a taxpayer—and that's a good example of a fairly simple one actually—presents us with a problem they have, and it's a reasonable problem, we should take ownership of that problem and not try to bounce it back either from one office to another within the IRS, or as in this case, bounce it back to the taxpayer. And we're attempting to do that.

I think there is some success in that. If you look at these problem-solving days that we've had, that's a perfect example of what we're trying to do where we've had office hours open at relatively convenient times like nights and weekends and taxpayers who had a problem, whatever it is, could come in and talk to somebody face to face. And the big point, though, is not just that we're open and they can talk face to face, but we've made a commitment that will take ownership of that problem and do the best we can to resolve it. It won't always be resolved to the satisfaction of the taxpayer.

And you know, it's interesting. Taxpayers are pretty intelligent in this way. They understand the difference between getting the answer that they hope to get, which they can't always get, because it depends on the law versus getting the right kind of service and getting people to serve them correctly. And in these problem-solving days, we've gotten very good grades from taxpayers on that score. So I think those are some of the basic things. Now, beyond that, of course, as I said in my statement, we really have fundamental technology weaknesses in the IRS that put a burden on the employees.

Mr. KUCINICH. Let me ask you about that a minute if I may, Commissioner. The chairman has ably raised the issue for quite awhile now about the year 2000 and the impact that's going to have, this so-called Y2K dilemma, which all agencies are facing. But in other hearings we've had, we've also had the issue of the vulnerability of government computers to hackers. I can't think of any area which could yield a better windfall for hackers than to have the opportunity to go into the IRS systems and rearrange some accounts.

My question to you is, since you admit that your technology is weak to handle the existing system absent interference, how is your system set up to handle hacking? How serious a problem is it, and have you identified losses of revenue because of it?

Mr. ROSSOTTI. Well, first of all, it's absolutely a serious problem and there are hackers that attempt to get into our web site and other places, you know, from time to time. Without a doubt, it's a serious problem, and we in fact established—before I got there—a special security office to focus on precisely this problem led by two people; one of which whom came from GAO. They are actually very excellent people, who are focused precisely on identifying and preventing those threats. But has this actually resulted in any loss of revenue or rearrangement of accounts? I don't believe that it has, and I think the reason is simply because knowing the seriousness of this threat, the basic strategy is to wall off our internal systems and not allow external access to them, which is one of the reasons why the electronic filing process is not as simple as we would like it to be.

I mean, the issue of how to advance electronic filing and electronic commerce in general, while still dealing with the security problem, is one of the really difficult tradeoffs that we have to make. So we're doing it very carefully.

Mr. KUCINICH. I appreciate you saying that; you don't believe you lost any revenue, but let me ask another subtly different question. How secure is the personal information which taxpayers give to IRS, which as all of us understand, is highly personal, how secure is that information?

Mr. ROSSOTTI. Well, I think the answer I gave was not just limited to revenue. I think that there is—I'm not aware of any instances where there has been any personal taxpayer information that's been accessed through hackers because of the point I made earlier. I said that all of the sensitive information is walled off, it isn't available. I mean it's fire walled from any external access. So this is basically the strategy that has to be pursued, and we have to be very careful to make sure that it stays walled-off.

It does present the difficulty of trying to make information more accessible and get more electronic filing, while still maintaining the security. So this is one of the things that slows us down, but it has to because we have to be secure in terms of our data.

Mr. KUCINICH. What do you do when you've identified that a hacker has attempted to attack the IRS data base?

Mr. ROSSOTTI. Of course, right now it's limited to things that can come in on the Internet, which is walled off from our basic internal data, but as I say, there are a number of offices that focus on that, and the most important office is the one within information technology that basically tries to track these problems and make sure that we've got the security systems in place to not let them penetrate our data. But we also have within our inspection service an internal security small unit with a few people who really focus on that and are specialized in trying to investigate those kinds of threats.

Mr. KUCINICH. I'd like to direct a question to Mr. Musick. The GAO identified weaknesses in IRS controls over cash receipts at its tax service centers. For example, it noted that individuals opening checks and cash and observed payments were not logged or recorded at the point of receipt to immediately assure accountability. What does the IRS—what's their view as far as current controls over cash and checks at service centers?

Mr. MUSICK. Well, on that specific issue, I think that you will probably note that the GAO also gave us some credit for identifying that ourselves as a problem, and there has been an effort underway for the last several months in every service center to track that. But the focus would be to get control over that check as soon as it comes in the door; get it stamped in, and get it controlled. I think that we're looking at all procedures in all service centers, and then there will be a consolidated look by service center directors, considering all those issues to get control over those checks.

Mr. KUCINICH. Let it be said that, that issue was raised as a matter of record, but it should also be said that I think we can have confidence that most of the people who work for IRS are honest, diligent Americans who are doing the right thing and making sure that they take total custody and care with taxpayers' dollars. But that's why it's unusual to hear of problems with the handling of cash receipts, and it's comforting to know that, not only that you brought that up, but you're taking care to assure better handling of cash.

At this point, I'd be glad to yield back my time.

[The prepared statement of Mr. Kucinich follows:]

Statement of the Honorable Dennis Kucinich
GMIT Subcommittee: Oversight of IRS Management
April 15, 1998

Today is the deadline for taxpayers to file their tax returns. It is therefore appropriate to reflect on how well our tax collection system is working, a system that -- perhaps amazingly -- relies primarily on voluntary compliance with tax laws. Voluntary compliance cannot be effective if the American people lack confidence in the IRS, the agency responsible for processing federal taxes. Without taxes, our government could not provide the protection, benefits and services upon which we all rely and that we too often take for granted. Thus it is imperative to the well-being of this country that the IRS successfully fulfill its mission to collect the right amount of tax at the least cost to the taxpayers and to perform this service with the "highest degree of public confidence in [IRS] integrity, efficiency and fairness."

We have a chance today to meet the new IRS Commissioner who is charged with upholding this public trust. Commissioner Rossotti, I'd like to thank you for taking time out from what I know must be a busy day for you to speak to us. We will explore in this hearing some of the most significant management challenges facing the IRS in its modernization efforts.

Consider what the IRS does on an annual basis. The agency processes tax returns from over 200 million taxpayers each year. It reviews more than 2 billion documents. The IRS collects over $1.5 trillion in revenue. Fifty two million refunds, totaling over $72 billion, have already been issued to taxpayers this year.

Recent reports, however, indicate that IRS employees accomplish many of these tasks with technology that dates back to the 1970's -- if not earlier. Last year, the IRS submitted a technology modernization blueprint, which proposes to manage technology investments, provide a technology architecture, and analyze the technical requirements of the IRS' business. Just recently, the agency set out to engage a prime contractor for the blueprint. It is clear that the IRS needs to follow through and implement a technology modernization program as quickly as possible.

At the same time, the agency is pursuing some modern technological initiatives, such as electronic filing. It has already experienced more than a 25% increase in electronically filed returns compared to this time last year. The IRS webpage, which allows taxpayers to download tax forms and applications, has had over a 200% increase in the number of computer "hits" compared with this time last year.

The IRS also is trying to improve its approach to customer service. Compared with this time last year, there was a 38% increase in the number of taxpayers whose calls got through to the IRS on its toll-free phone line.

Over 26 million calls were placed to the IRS using this toll-free number during the 1998 filing season.

Moreover, Commissioner Rossotti proposes an IRS modernization plan designed along customer lines that appears to make good business sense and should increase the level and quality of services provided to each of the IRS' customers. Borrowing relevant ideas from the private sector and developing employee incentives that foster customer service are valuable new initiatives. This kind of innovation is welcome and represents a creative approach to fashioning a more modern operation.

At this time, we are also ushering in a new era of federal agency management. Agencies recognize that they must not only provide top-quality government services, but also achieve them in a cost effective and efficient manner. Agencies must develop financial management systems capable of tracking their ongoing financial condition, assessing their financial vulnerabilities, and determining the most cost effective approach.

Today's hearing will also focus on the IRS financial audit. Although the year-end financial information provided by IRS is considered reliable, the GAO identified several significant material weaknesses in IRS financial systems that need to be corrected. These problems prevent the IRS from complying with several financial management laws and requirements. The IRS plans to address its weaknesses, with actions implemented over the next few years.

Given the importance of financial management requirements, we must be vigilant not to let implementation of IRS corrective action plans fall through the cracks. For example, the GAO highlights distortions inherent in the IRS' unpaid assessments. As a result, the IRS is unable to accurately document its financial condition on an ongoing basis. It will continue to lack this ability until it can more accurately document and track the collectible portion of its unpaid assessments (or tax receivables).

We anticipate criticism of the IRS today. I hope that the Commissioner will consider and respond to any constructive criticism that is legitimately offered in the spirit of improving the IRS. It is important that abuses and inappropriate practices by the IRS be identified and remedied wherever they exist. I think that the Commissioner would agree with me on this.

Ultimately, however, we must view our criticisms in the context of the important services that IRS provides. Consider for a moment from the IRS perspective the 25 million returns filed within just the <u>last 3 days</u>. While most taxpayers have finished their taxes, much work lies ahead for the IRS. I think we can all appreciate the monumental nature of the IRS' mission and its significance. So, as we work together constructively to improve both the financial management and overall management systems at the IRS, let's not forget that the IRS does a very difficult job well.

Mr. HORN. Yes, we'll have more time to pursue some of the questioning. Let me just go into a couple of issues that are going to be raised after you leave, by various witnesses that represent a part of, shall we say, the IRS outside community, such as the American Bar Association Section on Taxation.

One of the things their witness will recommend is that there should be an Under Secretary of Taxation to whom the Assistant Secretary for Tax Policy would report and the Commissioner of IRS would report. Do you have any feelings on that proposal?

Mr. ROSSOTTI. Well Mr. Chairman, I think I'm having enough work reorganizing the whole IRS without reorganizing the Treasury Department. I really don't have any comment on that. I think that would be a matter for the Secretary and the administration really to talk about.

Mr. HORN. I have a greatly dubious view about it personally. I think when you have major operational groups within a particular department, I think the Commissioner should report directly to the Secretary. That's such a sensitive area, it seems to me that would be one route.

Now, the other possibility here is to whom should the general counsel of IRS report? You, the general counsel of Treasury, or the Under Secretary of Taxation that the Taxation Section of the American Bar suggests that be the outcome? How do you feel about where the general counsel of IRS should report?

Mr. ROSSOTTI. Well, I mean, of course, I've only been here 4 months, and I have to say that is not an area that I've had a lot of problems with. I mean, it's been working OK from my point of view, and I've tried to focus my priorities where the need is the greatest. I told Stewart Brown after I'd been there a couple months, the Chief Counsel, I said, "look, your area doesn't seem broke, OK, so I'm going to work on some other stuff. Just keep going."

I mean so I suppose there are some arguments longer term being serious about it, but you can argue it either way. But it hasn't been one, honestly, that I focused a lot of my attention on because it seems to be working OK.

Mr. HORN. In terms of the types of work that the general counsel currently does, do you feel that that counsel should really report to the Commissioner because they affect policy issues with which you're concerned?

Mr. ROSSOTTI. As I said, Mr. Chairman, I've said that I don't see a need to change it from the way it is now. It seems to be working OK. If there is a proposal in the legislation to change it, and if they change it I'm sure that will be fine, too. It just hasn't been one of the areas, honestly, to be realized that I've focused a lot of attention on, thinking through one way or the other, and it does seem to be working fine. As I said, there are a lot of other areas that I don't think are working so well, so I focus my attention on those. So I'm just being honest. I haven't really given that one a lot of thought.

Mr. HORN. I can appreciate that, but when you were a chief executive officer, I assume the general counsel reported to you.

Mr. ROSSOTTI. That's right.

Mr. HORN. I would think that's the normal way general counsels report, and I guess I worry about an independent general counsel that does heaven knows what, when you're the people—you and the Secretary—that Congress is holding responsible. And if you don't have control over your own lawyers, to a sense it just seems a strange thing. So that's why I wanted to bring it up.

Now this, as you know, the reform bill, so-called, is over in the Senate. It hasn't been acted on yet. The question is should that board be advisory rather than a governing board? Any feelings on that?

Mr. ROSSOTTI. Well, I think that the way that it has been structured in the legislation as it passed the Senate Finance Committee in terms of the powers of the board goes, I think, strike a good balance. I mean this has been debated a lot and there has been a lot of good discussion about how this would work in the context of a government agency like the IRS.

I guess I would say that I would very much support the legislation. As it is in the Senate right now, I think it strikes a good balance. It does give quite a few powers to the board, and it, of course, interacts with the question that you raised earlier about what should be the case and how it should be organized in the Treasury Department because if the legislation goes through, you will now have a new element which will be this board, which will have not complete powers in the sense of a corporate board, but pretty important powers. And I'm optimistic that if we can get the right kind of people appointed to this board, it can provide some fresh perspective, private sector perspective, and a longer term perspective with some continuity than maybe we've had before, which was one of the things that Senator Kerrey and Congressman Portman tried to design in their proposal.

So I think it strikes a pretty good balance, and I think that in that regard, the legislation is very helpful, and I just hope it can be passed as soon as possible.

Mr. HORN. Another area that we should discuss is when a taxpayer has a grievance with the IRS as to what routes they should pursue, should they pursue an administrative law judge route that may be a group of administrative law judges that are within Treasury, but not within IRS? That is certainly what some agencies do. Should there be a special appeal process set up? Do you have any thinking on that at this point?

Mr. ROSSOTTI. Actually, I think that here again this legislation has some good things. I mean the IRS actually has an appeal process that's quite independent of the other functions and which is one of the things to which even the strongest critics have given quite good marks. Now, it hasn't operated across all the dimension of the IRS as much as it could, and in the legislative proposal there is—one of the provisions is to require or to set it up so that this appeals group will have more involvement in certain kinds of collection cases, which have been some of the more difficult cases that we've had.

Right now, it focuses more on the exam cases, and I think that seems to be the direction that the Senate favors, and I think that's actually a very good direction because we do have this process set up. It really is quite independent of the enforcement functions, and

I think most people give it pretty good marks for doing an independent job.

So I think we can make use of it effectively in some of the newer areas that have been identified and that could be a good solution.

Mr. HORN. A proposal has been made that there should be an independent Inspector General solely within IRS. Right now the Inspector General of the Department of the Treasury would handle matters within IRS. Any comment on that?

Mr. ROSSOTTI. Well, again, this legislation has some big changes in mind. As it is now, actually there is a rather large inspection service. It's over 1,100 people that cover both audit and investigations. And that is part of the IRS reports although it's independent of the other functions. Then on top of that, you have got now the Treasury Inspector General that has certain authority.

As I understand the current proposal and the Senate bill, it would take a major part of the inspection service out of the IRS and create another Inspector General group that would be solely focused on tax administration in order to give a greater degree of independence than is perceived to exist today. I've argued that there are perhaps ways that you could strengthen the independence of the existing inspection service and convert it in to effect an Inspector General within the IRS.

I think the Senate has decided that's not quite sufficient for them, and they want to actually move part of it up to the Treasury. I think that can work. I think we can live with that. There were certain requests that I suggested be put into that legislation if they were going to do it that way, which they tried, the Senate Finance Committee has tried to accommodate, so I think we're moving in the direction of whether it be done the way it's done in the Senate bill or some other way, to having a greater degree of independence than currently is perceived to exist with the inspection service, which I think is good. I support that. It is somewhat still open exactly how that's accomplished.

Mr. HORN. The gentleman from Ohio and you exchanged thoughts on computer security. How about noncomputer security? For example, when the cash comes in and various checks—as I understand the General Accounting Office report—there is no real lockbox. It goes through maybe three or four different layers where checks could be removed, altered in some way.

How much of a problem is that? Also, right now you have no surveillance cameras, I believe, and I wonder if that is because of a problem with the Treasury Employees Union and is something that has to be negotiated or how much have you had a chance to look at just plain old security?

Mr. ROSSOTTI. I'm going to ask Mr. Musick to answer part of that, but let me just make one comment just so you're aware of this. Actually the part of the problem we're dealing with here is only the part that deals with the checks that actually come into the IRS service centers, which is the vast minority of the money that comes in because most of the money actually comes in electronically now through our banks through the Federal Deposit System or through lockboxes which we do outsource.

Most of the checks actually come in through banks indirectly into the lockbox, which unfortunately actually was the cause of that problem that was in the newspapers. So we're only talking about the checks which come into the service centers, and there is where the issue is identified. But I will ask Mr. Musick to answer that question about the surveillance.

Mr. MUSICK. Well, on the surveillance issue, again, I would have to say that the group that Mr. Rossotti referred to, the security unit, has taken a look at all surveillance, all security issues, not only computer security, but fiscal security around service centers and within service centers. They have that broken down in an effort to try to address all service center issues and all district offices over the next few years. But, again, that's going to be an extensive effort, and they're going to have to take a look at some of the risks and the funding that we have to try to take care of those issues.

Mr. ROSSOTTI. I mean the truth is that apparently, as I understand it, up until a couple of years ago, there wasn't really a defined group that was in charge of specifically looking at these security issues, and the initiative was taken about a year ago or whenever, approximately a year or 2 years ago, to set up this special security group with some very, very qualified people and the leader of this group came from GAO. They're not only looking at computer security; they're looking at everything from fences to surveillance cameras, and a lot has been done especially in the computing centers. I think the service centers still need more work.

Mr. HORN. I thank the gentleman and now yield 10 minutes to the gentleman from Ohio, Mr. Kucinich.

Mr. KUCINICH. Thank you very much, Mr. Chairman. Back to Chairman Rossotti. Do you plan to modify the technology modernization blueprint so that it reflects the concepts in your modernization plan, and if so, will this dramatically affect the implementation and projected costs of the technology modernization blueprint?

Mr. ROSSOTTI. Yes, that's an excellent question. We tried to look at that very, very carefully, and I think that the answer is really this way; that the way the blueprint is set up now I think it is very appropriate and very much supports the direction that we want to go organizationally as well. It's set up in such a way that it only has detailed specifications for the very beginning, the very first two pieces of the blueprint, and those are very generic, very general kinds of communications technology which will support any organization structure.

As we get downstream, as we get further along into the later releases, as they're called, there will be changes undoubtedly, but those are releases that haven't really been defined in detail. We have more than enough time to do that, and I will provide Mr. Kucinich and the committee a chart which shows how all this fits together, if you would like, that just sort of summarizes on the page the time line. However, the basic idea is that this year, 1998, we're really focused heads down on the year 2000 problem to get most of the renovation done in 1999.

We intend to award the prime contract about the end of this year toward December 1999 and really—December 1998, and then in 1999, and in the early part of year 2000 we would be working on primarily these early releases that are very general that are more or less the foundation for the future work. Then, you know, by the time we get to about 2 years down after the year 2000 has turned, we will have also, we hope, been well down the road in terms of our organizational changes, and then we will really begin to work on some of the more specific business systems.

So I mean part of what this says, of course, is this is a long-term process. I mean we're talking about years here, and we have to do it in small pieces in order to control the risk.

Mr. KUCINICH. What's your target date for making sure that your system is in place for the year 2000? I mean you obviously need lead time to prepare for a tax year. What's the date?

Mr. ROSSOTTI. The date is to get—the target date is to get done virtually or nearly all of the replacement or renovation of the computer programs and the related infrastructure such as the communications network and the tax law changes, which are many this year, by January 1999 prior to the next tax season, and then, of course, we have the tax season. That then gives us the remainder of 1999 to do a very comprehensive test, which is absolutely required.

I mean you absolutely have to do this comprehensive test because there are many things changing. That's the grand strategy here, and you know we're focusing every day on trying to make that happen.

Mr. KUCINICH. I know you'll keep this committee posted because if it doesn't happen on time, we would like the privilege of declaring a taxpayer's holiday.

In your testimony you highlighted the need for restructuring legislation to include the flexibility of hiring a leadership team and a technical team. Why do you need legislation to do that?

Mr. ROSSOTTI. Well, of course, we are doing some of that now. We are in the current legislation. But there are some restrictions on, for example, the ability to bring in people, and many of the people that we may want to bring in, and I'm only talking a restricted number here. I mean we're not talking about hundreds of people, but it's 20 or 30 people. Many are not going to come in necessarily for a whole career in the government. They may be coming in for 3- or 4-year periods, and right now the provisions are not too—they don't make it too easy to do that. Also, frankly, the ability to adjust some of the pay ceilings is another key item in this bill that would give a restricted number of people the ability to increase the pay ceiling. So those are two of the important things.

Also, with respect to the general work force, there are some authorities in there that would allow us to experiment with different kinds of pay and grading schemes for different kinds of workers, which would also be helpful.

Mr. KUCINICH. I'm again appreciative of your presence here particularly given the day today, but also it's significant that you are here and it's important that you're here today because this is a day when people need to hear from their government and from the IRS as to issues of accountability, and you've certainly prepared yourself well for this day. I have a question that gets a little bit away from the technical issues here and back to issues that relate to the sensitivity of the IRS to the taxpayers.

Occasionally, in my office, I'll receive calls from people who feel that they're being treated harshly. Of course, I imagine it's very difficult to ask people to pay bills that might be substantial bills to IRS, and do it in a way that's always sensitive. What do you do as far as training personnel to make sure that in these very difficult and sensitive moments of encounter with the taxpayers that they're treating people with the utmost respect and courtesy?

Mr. ROSSOTTI. Yes, Mr. Kucinich, I do see that problem and I absolutely agree with that. That is very, very important. I think you know, as I said, one of the overriding principles that I'm at least trying to sensitize people to, or get the whole IRS to buy into, is the idea that we're there to help people solve problems. Even in the most difficult situations, we need to try to help people figure out the best way to cope with the situation they have.

Mr. KUCINICH. Do you have training programs where you go over these situations?

Mr. ROSSOTTI. Well, as I was going to say, one of the issues is that it's a combination of things. It's not going to happen overnight. One of the big points is simply getting across the idea that this is our goal, OK, that this is one of the things that we need to do in setting up examples of how it can be done. The problem-solving days that we did were very good examples.

I mean the employees very much liked that because we did bring people together, and we said, look, they were called problem-solving days and we took ownership of those problems. I would say approximately the numbers were 60 percent of the taxpayers were able to get the resolution the way they wanted it, and the other 40 percent did not. About 95 percent of the cases were closed in a way that at least was able to get the taxpayer to recognize, OK, this is the best we can do and this is the solution people gave us——

Mr. KUCINICH. I'd like to interject a different measure here though, and that is there is an inherently unequal power relationship between the IRS and the ordinary taxpayer; you will admit that. And given that, that's implicit in the exchanges that take place, how do you sensitize the employees about their exchanges because they're really coming from a position of tremendous power to reach into someone's personal finances. What do you do? What do you tell the IRS employees about how they need to regard that powerful position they have?

Mr. ROSSOTTI. Well, again I think that this is one of the fundamental cultural changes that we need to make, which is to sensitize and to explain to people that the goal is not only to collect the money and to get the result that the law provides, but to try to find the best way to help the taxpayer understand that situation and cope with it. And part of it is simply changing the whole strategy of what we do, but part of it is also training. I didn't get a chance to answer your other question. There is a lot more that we need to do with training. I mean you mentioned that, but I'm sorry I didn't respond to it.

In the next season that we're going through, in the 1999 season, we're going to put a special emphasis on training, and there are really two kinds of training. There's technical training to explain what the tax law is, but there is also training on how to deal with conflict situations where there's conflict. There are training modules that are available to deal with these kinds of things. We're going to try to do more of that within the IRS to train people, and I think there is a third one. There are two more.

One is a measurement system. I mean one of the things that's been observed is that if employees are measured solely on the basis of the business results and worse yet, just how much money they collect, that's going to drive people in one direction. We really are changing that very radically. This makes a big difference.

We're going to measure eventually every transaction that we have with the taxpayer from, the taxpayer's point of view. In other words, we're going to do like business, we're going to actually ask taxpayers, even on audits and collection actions. We're starting to do this on a test basis now. We're going to ask them to rate us on how well they have been served by that transaction. We did this on an experimental basis with these problem-solving days, and we're eventually, and I say this is going to take a few years. We're going to eventually build that into the performance evaluation system so that people are evaluated not just on the business results, but how it appeared to the taxpayer.

Mr. KUCINICH. Well, I think people really are concerned, Commissioner, about how they're treated. I mean that's how so much of the issue about IRS reform came about because there is a perception out there. Now, it may not be justified in 99 percent of the cases, but there is a perception out there that people are not always treated courteously or fairly, and it's heartening to know that you're addressing the culture of the IRS in its relationship with the taxpayer because I think what's important for everyone to know is all of those public servants work for the taxpayers.

I mean, you know, while we want to make sure that we get the revenue, we need to run the country. Still our government and the IRS should never be, I think, separated from the responsibilities and accountability that we would expect of other government officials in terms of courteousness and even kindness, and that might be a tough thing to raise when you're trying to collect the debt, but the fact of the matter is that—and maybe we're asking people to do more than is humanly possible—but at the IRS, given the power that the IRS has, I think that it's appropriate to request that a little bit more be done in terms of respecting the inequality of the situation and of asking for the employees to bend over backward to be courteous and kind to the public.

Mr. ROSSOTTI. I could not agree with you more. That is basically the whole thrust of what we are trying to do with the IRS.

Mr. KUCINICH. Thank you.

Mr. HORN. Do you have any more?

Mr. KUCINICH. I am concluded with Mr. Rossotti. Thank you.

Mr. HORN. Commissioner, just a few final questions here. We talked earlier about the write-off of money, the deal of collecting, and so forth. A lot of those, as I mentioned earlier, we know are bankruptcy cases that go in and out. Many are very legitimate. Some aren't. They just go in, they go out, they change the company's name, they duck taxes right and left, they don't give the employees their Social Security accounts and all that. Then, they spend the money themselves.

How many cases like that does the IRS discover and look at? And, with the taxpayer identification number, can't we collect down the line when they go through all these other bankruptcies which are just a way of doing business for them?

Mr. ROSSOTTI. Yes. I honestly don't know the answer to your question of how many cases there are that would fit into the category of, I guess you would say, willful sort of scheming to avoid the tax debt. I don't know. Maybe I might ask one of my colleagues. Do we have the data on that, John?

Could I ask one of my colleagues to come up?

Mr. HORN. Well, we have to swear him in if he starts talking. Can he whisper into your ear and you talk? That is not unusual in government or Congress.

Mr. ROSSOTTI. I have to be very honest and tell you that I have an awful lot still to learn about the IRS and all of the different aspects of it. But this is John Dalrymple, and he is an expert on these matters.

Mr. HORN. I will swear you in then.

[Witness sworn.]

Mr. HORN. The gentleman affirmed, the clerk will note, and you might spell your name for the record.

Mr. DALRYMPLE. My last name is spelled D-A-L-R-Y-M-P-L-E. The situation——

Mr. HORN. Bring the mic a little closer to you there.

Mr. DALRYMPLE. The situation you described is really one that is vexing because it does happen. I don't have numbers with me today, but there are definitely aspects of business where people start businesses, bankrupt the business, move on, start another business, bankrupt the business, and move on again.

We do follow those folks through those schemes. In fact, I think the description you raise primarily gives us difficulties where it is a corporation. We do have what is called the trust fund recovery penalty that we do impose, and that basically relates to the trust fund moneys that the business would have withheld from those employees that you mentioned, and those employees do get credit for the withholding on their tax return when they file.

So the government is out the money. And we do hold them responsible. We do follow them to whatever new avenue that they pursue, and we attempt to collect from them at that point in time based on assets that they may have. We have collection tools available to us in terms of transferee assessments where we can transfer one type of liability to a new entity, if they took assets from the old company and tried to put them in a new company. So we do have tools available to us to do that.

Mr. HORN. Are there any other tools that Congress should provide to deal with that type of situation?

Mr. DALRYMPLE. I think our tools are adequate. I think what is vexing about it is in many situations these types of folks live on the very fringe in the sense that they don't have much to begin with and they didn't have much when the business went out of business. So their assets are limited in terms of collecting from them. But in terms of people that do have assets, we have the ability and the tools to deal with them.

Mr. HORN. OK. Commissioner, I think the American public would like to know, did you complete your tax filing yourself or did you use your friendly accountant?

Mr. ROSSOTTI. Mr. Chairman, I have been working with an accountant for about 20 years, and I continue to work with him.

Mr. HORN. Well, I will confess that since 1970, I have turned it over to my wife and she works with the friendly accountant. But I did suggest when I first came to Congress in 1993 that all Members of Congress on April 15th, this day, should be assembled on the floor of the House, no accountants, no tax lawyers, make out their own forms, and I think we would have tax reform a lot faster around here if 435 of us did that on the floor of the House. But I can't get any takers on that idea, and we will just have to keep sort of limping along, or as the British say, muddling through. Since this will be the last question, I would like to know what you would like to tell the American people?

Mr. ROSSOTTI. I would like to say that I do believe that with the help of the Congress and the forbearance of the public for some period of time, we really can convert the IRS into an agency that views its mission as helping people comply with their obligations and the tax law and not as it is sometimes viewed as an adversary. I don't believe there is any reason why, except in the rare cases where people want us to be adversaries, but for the majority of taxpayers, the vast majority of taxpayers who are willing to comply, they should be treated like customers, like valued people that we are helping to figure out how to cope. That even goes for the cases where there may be some difficulty, not just the routine cases, but the difficult cases. And I would certainly not claim that we are there yet, although there has been some progress, even in this filing season.

So with your help and that of the public, I do believe we can make that happen. I don't believe it is impossible.

Mr. HORN. Well, I thank you for coming before us. We will probably do these every April 15th, so put them on your calendar. We have great faith in you. I think if anybody can turn that agency around and get it going in the direction that you want it to go, and have articulated so well, I think you are the person to do it. You come with the right background, the right experience. You have built a major firm, have been a chief executive officer, and can provide leadership. And that is where I think, despite some very fine people being commissioners over the years, we simply haven't had the executive managerial leadership that an agency of 102,000 employees really need and deserve. So I thank you very much for coming, and wish you well.

Mr. ROSSOTTI. Thank you, Mr. Chairman.

Mr. HORN. Mr. Musick, have you got a few minutes where you could just join us with the General Accounting Office? We will get into some of the nitty-gritty?

Mr. MUSICK. Yes, sir.

Mr. HORN. You are an expert on that. I need your wisdom on this one.

So panel II, the General Accounting Office, will come forward, Mr. Musick will stay at the table and we might clarify some questions. Mr. Dodaro and staff.

Ladies and gentlemen, stand, raise your right hands.

[Witnesses sworn.]

Mr. HORN. You will note that all four witnesses from the General Accounting Office did affirm the oath.

It is always good to see our friend, Mr. Dodaro, the Assistant Comptroller General of the United States on the management front, and we thank you. You have written us an excellent presentation here, and please proceed.

STATEMENT OF GENE L. DODARO, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LINDA WILLIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION; GREGORY D. KUTZ, ASSOCIATE DIRECTOR, GOVERNMENTWIDE ACCOUNTING AND FINANCIAL MANAGEMENT, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION; AND STEVEN SEBASTIAN, ASSISTANT DIRECTOR, GOVERNMENTWIDE ACCOUNTING AND FINANCIAL MANAGEMENT, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION

Mr. DODARO. Good morning, Mr. Chairman, Congressman Kucinich. It is a pleasure to be here today to discuss the results of our most recent audit of IRS's custodial financial statements. These statements are very important because they report the results of IRS's responsibilities in implementing tax legislation. For fiscal year 1997, for example, they included the results of revenue collection activity of $1.6 trillion of revenue, which is the vast majority of the revenue collected to run the government, as well as about $142 billion of refunds.

As has been highlighted this morning, GAO has issued an unqualified opinion on IRS's custodial financial statements for the first time. This has been a result of years of hard work by IRS and GAO and the result of sustained incremental improvements over the years.

I might also add, Mr. Chairman, it points to the value of congressional oversight hearings by this subcommittee over the past few years to really track the progress that IRS has made in improving financial management.

Now, all these efforts are producing some positive results. We have, for example, greater accountability now over taxpayer dollars that IRS is collecting. Also, the efforts are resulting in IRS having better information to manage their operations and also for the Congress to measure IRS performance and make funding decisions. A good illustration of this is illustrated by the chart to my right which begins to provide better insight into the composition of IRS's unpaid assessments that IRS has made. There has been great debate over the past few years about the size of that inventory of unpaid assessments and what is the real value of the collections that the government is expected to garner from those assessments.

As this chart shows, there were $214 billion of unpaid assessments for fiscal year 1997. Of that amount, only 13 percent, or about $28 billion, was estimated to be collectible.

Now, of the remaining amounts, there were write-offs for financial reporting purposes of basically defunct corporations, which included many failed S&Ls and banks. We also have a category of compliance assessments where IRS has made the assessment but the taxpayer or the court has not yet agreed that that is the proper assessment. There are also about $62 billion of receivables that have been deemed to be uncollectible; that is, the IRS has had difficulty either locating the taxpayer, or the taxpayer may be in the midst of bankruptcy proceedings, so currently that amount is not collectible.

Now, basically it is important to note, however, that while we are getting better information as to the year-end status of IRS's financial position, that as the Commissioner indicated, the IRS currently does not have timely, reliable information throughout the year. This is a fundamental problem that needs to be corrected.

Also, it will only be corrected by modernizing their computer systems. Unfortunately, this is going to take a number of years, as the Commissioner pointed out, and is also in the next couple of years going to have to take a back seat to the year 2000 conversion problem.

However, there are a few things that IRS can do in the short-term. No. 1, IRS needs to continue to produce reliable year-end financial statements so they can begin to have trend data from year to year and make comparative judgments as to, for example, the nature and composition of the unpaid assessments inventory at IRS.

Additionally, IRS needs to make, as has been noted, some improvements in the procedures on which it receives receipts in the service centers over taxpayer checks and also refunds that are issued. We are in the process of making recommendations to IRS in that regard. Also, IRS needs to continue to improve the security over its computer systems. They have taken some good measures, progress is being made, but there is quite a bit left to do, and we have been making recommendations to them in that area as well. Finally, IRS needs to make sure that its system development efforts begin to provide the type of requirements for its revenue accounting system and its accounts receivables areas that are going to be able to generate the type of timely information it needs to provide customer service and to begin collecting taxes that are owed earlier in the process.

Now, the Commissioner outlined some restructuring proposals which we think have considerable merit. In fact, they track many of the suggestions GAO has made over the years to improve IRS operations. However, in order for that restructuring proposal to work, these underlying financial management problems really need to be corrected. Any organizational structure will only be as effective as the type of timely and reliable information that it is provided to deal with taxpayers and to implement IRS's procedures.

We are committed to continuing our work with the IRS to achieve that goal over the long run.

Mr. Chairman, that concludes my opening remarks. My colleagues and I, and I know Mr. Musick, will be happy to answer any questions you might have.

[The prepared statement of Mr. Dodaro follows:]

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the results of our audit of the Internal Revenue Service's (IRS') fiscal year 1997 custodial financial statements.[1] This audit was performed in accordance with the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. The IRS custodial financial statements report the assets, liabilities and results of activities related to IRS' responsibilities for implementing federal tax legislation, including collecting federal tax revenues, refunding overpayments of taxes, and pursuing collections of amounts owed.[2]

After several years of concerted effort by IRS and GAO, we were, for the first time, able to conclude that IRS' custodial financial statements were reliable. In issuing an unqualified opinion on the fiscal year 1997 custodial statements within the statutory deadline of March 1, we reported that the over $1.6 trillion in tax revenue, $142 billion in tax refunds, and $28 billion in net taxes receivable reported by the IRS were fairly stated. We commend the significant effort that IRS officials made to achieve this major accomplishment.

These positive results show that focused attention by the Congress and this Subcommittee on IRS' financial management, which GAO has identified as a high risk area for many years, has begun to pay dividends. Such benefits include better information available to IRS management and to the Congress to help make decisions.

Because of the volume and sensitivity of the tax collections and refunds, the adequacy of IRS' financial systems deserves careful attention. Federal tax revenues dwarf most other financial activities undertaken by any single entity, public or private, in the world. The government relies upon IRS to collect the proper amount of tax revenues at the least cost to the public, serve the public by continually improving the quality of its products and services, and perform in a manner warranting the highest degree of public confidence in its integrity. Its revenue collections represent over 90 percent of the federal government's revenues. Therefore, it is imperative that IRS establish strong financial management and internal controls to effectively meet its mission.

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[1]See Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

[2]IRS' fiscal year 1997 administrative financial statements, which were audited by the Inspector General of the Department of the Treasury (Treasury), report on the financial position and results of operations related to the administration of IRS funded by appropriations and reimbursements from other agencies, state and local governments, and the public.

Prior to fiscal year 1997, we were unable to conclude that IRS' custodial financial statements were fairly stated, mainly because weaknesses in IRS' internal controls and financial management systems prevented it from producing reliable financial information.[3] Therefore, our ability to conclude that the fiscal year 1997 custodial financial statements were reliable was a mark of progress. However, this could only be accomplished after extensive use of ad hoc programming by IRS to extract data from its systems, followed by numerous adjustments totaling tens of billions of dollars to this data to produce the final financial statements.

During our fiscal year 1997 audit, we found IRS' internal controls remain plagued by weaknesses that affect its ability to timely report reliable financial information throughout the year, safeguard assets from loss, and assure full compliance with laws and regulations. We reported these weaknesses related to IRS's custodial activities as a material weakness in our report on the fiscal year 1997 consolidated financial statements of the U.S. government.[4] These weaknesses fall into the following areas:

- Unpaid assessments. For fiscal year 1997, we were able to report that most of IRS' unpaid assessments–amounts IRS had recorded as taxes due to the federal government but not yet paid–were not receivables and were largely uncollectible. Of the $214 billion in unpaid tax assessments, only $90 billion represented receivables of the government under federal accounting standards, and only $28 billion of these were estimated to be collectible. However, this information had to be developed through extracting data from IRS systems, analyzing this data, and making substantial adjustments to derive reasonable amounts. This condition exists because IRS' general ledger cannot identify the portion of unpaid assessments that represent taxes receivable, and because IRS does not have a subsidiary ledger to track unpaid assessments. These weaknesses impair IRS' ability to effectively manage its unpaid assessments.

- Receipts and Refunds. Vulnerabilities in controls over cash received and refunds disbursed weaken IRS' ability to assure that all government and taxpayer funds are properly protected. Cash and checks were not always properly controlled upon receipt, and flawed procedures allowed improper refunds to be issued. IRS

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[3]For fiscal year 1996, we were able to determine for the first time that total net revenue collections as reported in IRS' financial statements were reliable. However, we still could not conclude that IRS correctly classified tax receipts and refunds by tax type because IRS could not provide sufficient evidence supporting its classification. We also could not determine the reliability of reported net federal tax receivables, as in prior years.

[4]U.S. Government Financial Statements: Results of GAO's Fiscal Year 1997 Audit (GAO/T-AIMD-98-128, April 1, 1998).

must establish stronger controls over these areas to assure government and taxpayer funds are properly safeguarded.

- Revenue accounting and reporting. IRS cannot identify the specific amounts of revenue collected for certain major tax types at time of remittance. Additionally, IRS certifies amounts to be distributed to trust funds based on amounts assessed which, for excise taxes, is not in accordance with laws governing their distribution.

- Compliance with Federal Financial Management Improvement Act. IRS' financial management systems do not comply with the requirements of the Federal Financial Management Improvement Act of 1996.[5] Consequently, IRS' financial management systems cannot routinely produce reliable financial information for management decisionmaking and accountability.

- Computer Security. Controls over IRS' automated systems exhibit serious weaknesses in areas such as physical security, data communications management, and contingency planning. As a result, these weaknesses leave the IRS vulnerable to unauthorized access, enabling sensitive data and programs to be altered or deleted.

In total, these findings frame the remaining challenges that IRS still must meet to assure that it is able to effectively manage unpaid assessments; assure its financial systems are able to provide accurate, relevant, and timely management information; assure that funds are properly safeguarded; and assure its computer systems are properly designed and protected. IRS is taking steps to address these issues but additional efforts will be required to fully implement corrective measures.

The following sections outline our findings and related implications from the fiscal year 1997 audit for each of the five areas: unpaid assessments, safeguarding of assets, financial accounting and reporting, Federal Financial Management Improvement Act compliance, and computer systems. We also offer our observations on (1) the importance of IRS' preparation of its automated systems to be Year 2000 compliant, and (2) potential implications of the IRS Commissioner's proposal for restructuring the agency on IRS' financial operations.

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[5]The Federal Financial Management Improvement Act of 1996 mandates (1) certain financial management systems requirements for federal agencies, (2) auditors to report on agency compliance with the financial systems requirements, and (3) agency heads to correct identified deficiencies within a specified time period.

UNPAID ASSESSMENTS

Unpaid assessments consist of unpaid taxes that IRS has recorded as due to the government by taxpayers. Based on federal accounting standards, unpaid assessments are placed in one of the following three categories:

(1) taxes receivable, which are taxes due from taxpayers for which the IRS can support the existence of a receivable through taxpayer agreement (such as the filing of a tax return) or a court ruling favorable to IRS,

(2) compliance assessments, where neither the taxpayer nor the court has affirmed that the amounts are owed, such as an assessment resulting from an audit of the taxpayer, and

(3) write-offs, which are any unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's bankruptcy, insolvency, or death.

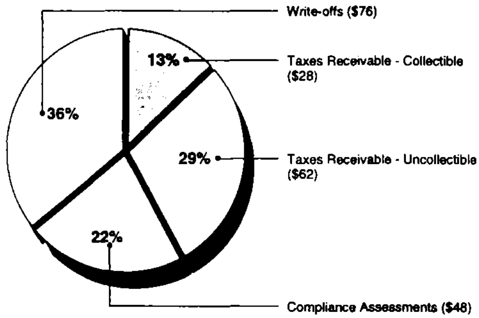
Because only taxes receivable are reportable in the financial statements, it is essential for IRS to be able to properly identify the portion of unpaid assessments that are receivables. To adequately pursue collection of these receivables, IRS must be able to readily identify the individual debtors and to support the amounts owed. We found that in fact most of IRS' recorded unpaid assessments are not receivables. In addition, several weaknesses prevent IRS from routinely identifying and tracking its receivables and from providing documentation supporting the amounts taxpayers purportedly owe.

Most Unpaid Assessments Are Not Receivables and Are Largely Uncollectible

As reflected in the supplemental information to IRS' fiscal year 1997 custodial financial statements, the unpaid assessments balance was about $214 billion at September 30, 1997. This balance has historically been referred to as IRS' taxes receivable or accounts receivable, even though taxes receivable make up only one component of unpaid assessments.

Figure 1 depicts the components of the unpaid assessments balance at September 30, 1997.

Figure 1: Components of IRS' $214 Billion of Unpaid Assessments (Dollars in Billions)



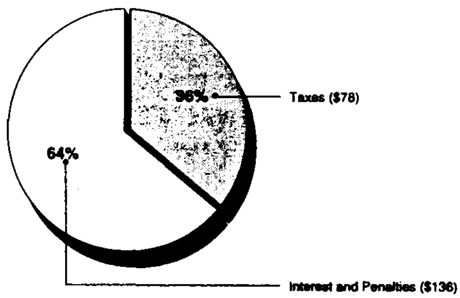
Of the $214 billion balance of unpaid assessments, $48 billion represent compliance assessments that have not been agreed to by either the taxpayer or a court. Due to the lack of agreement, these compliance assessments have significantly less potential for future collection than those unpaid assessments that are considered federal taxes receivable. $76 billion represent write-offs, which principally consist of payroll and corporate income taxes owed by bankrupt or defunct businesses, including many failed financial institutions closed or otherwise resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC).

The remaining $90 billion of unpaid assessments represent federal taxes receivable. About 70 percent–$62 billion–of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, such as individual taxpayers who are unemployed or having other financial problems. However, IRS may continue collection action for 10 years after the assessment or longer under certain conditions. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves. Only the remaining 30 percent–about $28 billion–of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals, as well as relatively newer amounts due from individuals and businesses who have a history of compliance.

Since traditionally the full amount of unpaid assessments has been equated with receivables, it is significant to note that after years of audit scrutiny, IRS has finally been able to determine that only $28 billion of its total unpaid assessments of $214 billion–about 13 percent–actually represent collectible taxes receivable. Thus, while the Congress and IRS may have been making decisions based on a presumed level of taxes receivable due the federal government, in fact only a small portion of that balance represented receivables for which collection could reasonably be expected. While such information is necessary for IRS to prepare reliable financial statements, on a broader level, good reliable financial data is essential to enable management to measure and report on IRS' performance and for the Congress to rely upon for making its budgeting decisions.

In addition, it is also important to note that of the unpaid assessments balance, about $136 billion (over 60 percent) represents interest and penalties, as depicted in figure 2, which are largely uncollectible.

Figure 2: Unpaid Taxes and Interest and Penalty Components of $214 Billion in Unpaid Assessments (Dollars in Billions)



Interest and penalties are a high percentage of the balance because IRS continues to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, despite no hope of collection, interest and penalties continue to accrue on write-offs such as FDIC and RTC cases, as well as on assessments made as a result of an audit of the taxpayer where the taxpayer has not agreed to the validity of the assessment. In fact, the overall growth in unpaid assessments during fiscal year 1997 was wholly attributable to the accrual of interest and penalties, rather than to any significant increase in taxes due the government.

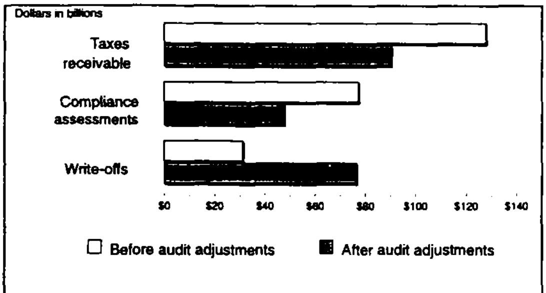
We plan to issue a separate report discussing the composition and collectibility of IRS' unpaid assessments in more detail.

General Ledger Cannot Separate Categories of Unpaid Assessments

While only the taxes receivable portion of unpaid assessments are reportable in the financial statements, IRS' general ledger system cannot separate the amount of gross or net taxes receivable from total unpaid assessments. Instead, IRS has to use special computer programs to extract unpaid assessment data from its master files--the only detailed record of taxpayer information it maintains--and classify these unpaid assessments into the three categories (taxes receivable, compliance assessments, and write-offs). IRS then analyzes those unpaid assessments classified as taxes receivable to estimate the amount deemed to be collectible (the net taxes receivable).

In our prior financial audits, IRS attempted to use this approach to determine the taxes receivable balance. However, various problems encountered in extracting the information as well as errors made in attempting to classify the amounts from the data extracted precluded us from determining that the amounts reported were reliable. For fiscal year 1997 we were able to determine that taxes receivable as reported in the financial statements were reliable, but this was only after significant adjustments totaling tens of billions of dollars were made. Figure 3 below illustrates the level of adjustments made to the fiscal year 1997 master file extractions in order to arrive at reliable, auditable amounts for each category.

Figure 3: Comparison of Unpaid Assessments Before and After Audit Adjustments



Source: IRS masterfiles and IRS fiscal year 1997 custodial financial statements

Note: The adjusted balance of taxes receivable presented above represents the gross taxes receivable (does not include the allowance for doubtful accounts). Additionally, the original unpaid assessment balance of $236 billion was adjusted to $214 billion, due primarily to duplicate assessments.

The most significant adjustments related to amounts that were originally reported as taxes receivable or compliance assessments but which were really write-offs. For example, 149 of the 626 items we sampled–about 24 percent–that were initially identified as taxes receivable in the master files were actually write-offs, and consisted primarily of corporate income and payroll taxes[6] owed by corporations that had been defunct for years. Similarly, 23 percent of the compliance assessments we sampled were also write-offs. The extensive reliance IRS must place on ad hoc procedures to identify actual taxes receivable and the significant adjustments necessary to make this data reliable raise serious questions about the integrity of unaudited IRS information and the ability of IRS to effectively manage its unpaid assessments.

IRS Lacks a Subsidiary Ledger To Track Unpaid Assessments

As we have reported in our previous financial audits, IRS does not have a detailed listing, or subsidiary ledger, which tracks and accumulates unpaid assessments on an ongoing basis. Such a subsidiary ledger could have compensated for the general ledger's inability to separate unpaid assessments. Additionally, the lack of a detailed subsidiary ledger also impairs IRS' ability to effectively manage the unpaid assessments.

For example, IRS' current systems cannot ensure that all parties liable for certain assessments get credit for payments made on those assessments. Specifically, payments made on unpaid payroll tax withholdings for a troubled company, which can be collectible from multiple individuals, are not always credited to each responsible party to reflect the reduction in their tax liability. In 53 of 83 cases we reviewed involving multiple individuals and companies, we found that payments were not accurately recorded to reflect the reduction in the tax liability of each responsible party. For example, in one case we reviewed, three individuals had multimillion dollar tax liability balances, as well as liens placed against their property, even though the tax had been fully paid by the company.

A proper subsidiary ledger for unpaid assessments is necessary to provide management with complete, up-to-date information about the amounts due from each taxpayer, so that managers will be in a position to make informed decisions about collection efforts and collectibility estimates. This requires a subsidiary ledger which makes readily available to management the amount, nature, and age of all unpaid assessments outstanding by tax liability and taxpayer, and which can be readily and

[6]Payroll tax withholdings are comprised of individual income tax withholdings and employer and employee withholdings for Federal Insurance Contribution Act (FICA), which include Social Security and Hospital Insurance taxes.

routinely reconciled to corresponding general ledger balances for financial reporting purposes. Such a system should also track and make available key information necessary to assess collectibility, such as account status, payment and default history, and installment agreement terms.

We will be issuing a separate report on this issue. In that report, we will be making recommendations to assist IRS in identifying the key components needed for an effective subsidiary ledger for unpaid assessments.

Documentation Improvements Are Still Needed

We also continued to find in our fiscal year 1997 audit that IRS has problems locating and providing supporting documentation for its unpaid assessments, primarily due to the age of the items. IRS has acknowledged problems with documentation and is working to make needed improvements in this area. We will continue to work with IRS in identifying ways to improve documentation.

VULNERABILITIES EXIST IN CONTROLS OVER RECEIPTS AND REFUNDS

Our fiscal year 1997 audit identified vulnerabilities in IRS' controls over both its receipts and refunds processes, which raise concerns over IRS' ability to protect the government's money. We found that IRS' controls over the receipt of cash and checks it receives directly from taxpayers are not adequate to assure that these payments will be properly credited to taxpayer accounts and deposited to the Treasury's general revenue fund. To ensure appropriate security over payments received at its lock box[7] depositories, IRS requires controls such as the use of a surveillance camera to monitor staff when they open mail containing cash and checks. However, we found that controls over cash payments received at the four IRS service centers where we tested such controls were not held to comparable standards. At these locations, IRS allowed individuals to open mail unobserved, relying on them to accurately report amounts received, and did not require payments received to be logged or otherwise recorded at the point of receipt to immediately establish accountability and thereby deter and detect diversion.

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[7]A lock box is a cash management service provided by banks under contract to IRS. Using this service, taxpayers mail payments to a post office box or a lock box facility where the contract banks collect the receipts, deposit them in Treasury's general revenue fund, and report the receipts to IRS.

In fact, accountability for cash and checks received at a service center is not established until the money has passed through several sets of hands, as illustrated in the Attachment to this statement.

Additionally, during our review we observed at one service center on several occasions that payments were being received by personnel who should not have been authorized to accept such payments. As a result of these weaknesses, IRS is vulnerable to losses of cash and checks received from taxpayers. In fact, between 1995 and 1997, IRS identified 80 instances of actual or alleged employee embezzlement of receipts totaling about $5.3 million. These actual and alleged embezzlements underscore the need for effective internal controls over the IRS' service center and district office receipts processes.

We also found that IRS did not have sufficient preventive controls over refunds to assure that inappropriate refunds were not disbursed. Such inappropriate payments have taken the form of refunds improperly issued or issued for incorrect amounts which IRS did not identify because of flawed IRS procedures, or fraud by IRS employees. For example, we found nine instances where refunds were paid for inappropriate amounts. Three of these occurred because IRS did not compare tax returns to the attached W-2s (Wage and Tax Statement) at the time the returns were initially processed, and consequently did not detect discrepancies with pertinent information on the tax returns. As we have reported in prior audits, such inconsistencies generally go undetected until such time as IRS completes its document matching program,[8] which can take as long as 18 months. In addition, during fiscal year 1997, IRS identified alleged employee embezzlement of refunds totaling over $269,000. IRS is also vulnerable to issuance of duplicate refunds made possible by gaps in IRS' controls. IRS reported this condition as a material weakness in its fiscal year 1997 Financial Managers' Financial Integrity Act report.

We will be reporting on these issues in more detail, and our recommendations for strengthening controls over receipts and refund processes, in a follow-on report on internal control issues at IRS.

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[8]This program involves matching tax return information with information provided by third parties (e.g., 1099, W-2) to identify any differences for further investigation.

REVENUE ACCOUNTING AND REPORTING

IRS is unable to currently determine the specific amount of revenue it actually collected for the Social Security, Hospital Insurance,[9] Highway, and other relevant trust funds. As we previously reported,[10] the primary reason for this weakness is that the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is not provided at the time that taxpayers remit payments. Information is provided on the tax return, which can be received as late as 9 months after a payment is submitted. However, the information on the return only pertains to the amount of the tax liability, not the distribution of the amounts previously collected. As a result, IRS cannot currently report actual revenue collected for Social Security, Hospital Insurance, Highway, and other trust funds nor can it accurately report revenue collected for individuals. Because of this weakness, IRS had to report FICA and individual income tax collections in the same line item on its Statement of Custodial Activity for fiscal year 1997. However, requirements for the form and content of governmentwide financial statements[11] require separate reporting of Social Security, Hospital Insurance, and individual income taxes collected. Beginning in fiscal year 1998, federal accounting standards[12] will also require this reporting.

Taxes collected by IRS on behalf of the federal government are deposited in the general revenue fund of the Treasury, where they are subsequently distributed to the appropriate trust funds. Amounts representing Social Security and Hospital Insurance taxes are distributed to their respective trust funds based on information certified by the Social Security Administration (SSA).[13] For excise taxes, IRS certifies the amounts

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[9]The Hospital Insurance Trust Fund (HI) is one of two trust funds comprising the accumulated funds of the Medicare program. The other Medicare trust fund is the Supplemental Medical Insurance Trust Fund (SMI). Of these trust funds, only HI receives distributions from the Treasury's general revenue fund.

[10]Financial Management: Important IRS Revenue Information is Unavailable or Unreliable (GAO/AFMD-94-22, December 21, 1993).

[11]OMB's Format and Instructions for the Form and Content of the Financial Statements of the U.S. Government (September 2, 1997).

[12]The Federal Accounting Standards Advisory Board recommends accounting standards, and OMB, Treasury, and GAO decide whether to adopt the recommended standards; if they are adopted, the standards are published by OMB and GAO.

[13]Social Security and Hospital Insurance taxes are required to be distributed based on a certification by the Commissioner of SSA. This certification is based on wage information maintained by SSA which may be augmented by IRS assessed amounts.

to be distributed based on taxes assessed, as reflected on the relevant tax forms. However, by law distributions of excise taxes are to be based on taxes actually collected.

We also found IRS did not have adequate controls over its process of certifying excise tax distributions to the appropriate trust funds. The lack of fundamental internal controls, such as supervisory review, resulted in a number of errors[14] that affected the amounts ultimately distributed to the trust funds. We found inadequacies in the review of excise tax:

- returns received, resulting in taxpayer errors on the returns going undetected;
- returns processed, resulting in IRS input errors going undetected; and,
- certifications prepared, resulting in human error in extracting and analyzing data from the master file going undetected.

As a result of these weaknesses, trust funds may not have received the proper amount of excise tax revenue during fiscal year 1997. In fact, these weaknesses were a contributing factor in the Department of Transportation Inspector General's qualified opinion on the fiscal year 1997 financial statements of the Highway Trust Fund.

IRS SYSTEMS DO NOT COMPLY WITH REQUIREMENTS

The Federal Financial Management Improvement Act of 1996 requires auditors performing financial audits to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. The Act's premise is that agencies that satisfy the Act's systems requirements will be better positioned to routinely produce complete and reliable financial information for managing operations and ensuring management accountability.

In our fiscal year 1997 audit of IRS, we reported that IRS' systems do not substantially comply with the requirements of the Act. For example, IRS' general ledger does not conform to the government standard general ledger at the transaction level. Additionally, IRS' lack of a subsidiary ledger for unpaid assessments does not comply with federal financial management systems requirements. In many respects, the status of IRS' systems mirrors what we found across the federal government. As we outlined in our report on the fiscal year 1997 consolidated financial statements of the U.S.

However, generally this certification is based on IRS assessed amounts.

[14]See Agreed-Upon Procedures: Excise Taxes (GAO/AIMD-98-78R, February 26, 1998).

government, the majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and thus cannot routinely provide reliable information for management decisionmaking and accountability.

We have previously reported on many of these issues in our IRS financial audits over the years and made recommendations for corrective action. Although IRS has drafted a plan of action intended to incrementally improve its financial reporting capabilities, which is scheduled to be fully implemented during fiscal year 1999, the plan falls short of fully meeting federal financial management system requirements. IRS also has a longer range plan to address the financial management system deficiencies noted in prior audits and in IRS' own self-assessment.[15] During future audits, we will monitor IRS' implementation of these initiatives, and assess their effectiveness in resolving the issues discussed above.

COMPUTER SYSTEMS ISSUES

IRS places extensive reliance on computer systems to process tax returns, maintain taxpayer data, calculate interest and penalties, and generate refunds. The huge volume of transactions it processes and the decentralized structure of the agency–which includes two computing centers, ten service centers, and numerous district offices nationwide–make its operations highly computer driven. In addition, the IRS Commissioner recently testified that electronic filing of returns and taxpayer use of its electronic payment system has significantly increased and usage is continuing to grow.[16] Consequently, it is critical that IRS maintain effective internal controls over these systems.

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[15]Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, February 24, 1998).

[16]Hearing on the 1998 Tax Return Filing Season and the IRS Budget for Fiscal Year 1999, Statement of Charles O. Rossotti, Commissioner, Internal Revenue Service, before the Committee on Ways and Means, Subcommittee on Oversight, March 31, 1998.

Controls Over Computer Security Are Inadequate

We previously reported that IRS had serious weaknesses in the controls used to safeguard its computer systems, facilities, and taxpayer data.[17] Our review of these controls as part of our audit of IRS' fiscal year 1997 custodial financial statements found that overall controls continued to be ineffective. IRS' controls over automated systems continued to exhibit significant weaknesses in areas such as physical security and data communications management. These weaknesses can allow unauthorized individuals access to critical hardware and software where they may intentionally or inadvertently add, alter, or delete sensitive data or programs. We have found that such weaknesses are widespread throughout the government, as discussed in our report on the fiscal year 1997 consolidated financial statements of the U.S. government.

IRS recognized these weaknesses in its fiscal year 1997 Financial Managers' Financial Integrity Act report and has corrected a significant number of the computer security weaknesses identified in our previous audits. Additionally, IRS has centralized responsibility for security and privacy issues and added staff in this area. IRS informed us it plans to substantially address the remaining weaknesses by June 1999. However, until corrected fully, IRS' automated systems remain vulnerable to losses, delays or interruptions in service, and compromise of the sensitive information entrusted to IRS by taxpayers. We are continuing to review IRS' efforts in this area, and plan to issue separate reports, by IRS location, on computer security issues we identify, along with recommendations for corrective action. We will also follow up on these issues as part of our fiscal year 1998 financial audit.

Success of IRS' Year 2000 Efforts Is Critical

It is critical that IRS successfully address its Year 2000 computing problem. The Year 2000 problem is rooted in the way dates are recorded and calculated in many computer systems. For the past several decades, systems have typically used two digits to represent the year in order to conserve on electronic data storage and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from the year 1900. As a result, systems hardware and software (system and application) that are date dependent may generate incorrect results, or fail to work at all, when processing years after 1999. We have reported this issue as a

[17]See Financial Audit: Examination of IRS' Fiscal Year 1996 Custodial Financial Statements (GAO/AIMD-98-18, December 24, 1997), and IRS Systems Security: Tax Processing Operations and Data Still at Risk Due to Serious Weaknesses (GAO/AIMD-97-49, April 8, 1997).

governmentwide high risk area,[18] and the President has designated it as a priority management objective. In addition, we discussed this as a serious governmentwide issue in both our report on the fiscal year 1997 consolidated financial statements of the U.S. government and in a recent hearing before this subcommittee.[19]

IRS has one of the largest conversion efforts in the civilian sector underway. IRS' goal is to complete all renovation efforts scheduled for completion by January 1999 in order to allow a full year of operational testing. However, with less than 21 months remaining, the task of completing renovation and testing on time is formidable. If IRS is unable to make its mission-critical systems Year 2000 compliant, IRS could be rendered unable to properly process tax returns, issue refunds, correctly calculate interest and penalties, effectively collect taxes, or prepare accurate financial statements and other financial reports. We are working with the Congress and the executive branch to strengthen our nation's Year 2000 efforts, including those of key sectors of our nation's economy as well as the associated efforts of key federal agencies. We specifically plan to review the effectiveness of IRS' Year 2000 program in conjunction with our fiscal year 1998 financial audit.

COMMENTS ON IRS RESTRUCTURING

Over the past decade, IRS has proposed and initiated many efforts aimed at reengineering its business processes and modernizing its computer systems. Some of these efforts have resulted in improvements in the way IRS conducts its business and deals with taxpayers. Nonetheless, it is widely recognized that much more needs to be done.

Commissioner Rossotti recently announced his plans for modernizing the IRS. The overriding concept of the plan is to change the IRS from an internally-focused organization to one that emphasizes assistance to taxpayers in complying with the tax laws and ensures the fair treatment of taxpayers. While IRS has announced many plans for restructuring and modernization over the past decade, Mr. Rossotti's plan appears to go far beyond past proposals by, among other things, changing IRS' organizational structure to reflect a new focus. The Commissioner has categorized his proposed changes into several key areas, among them (1) an organizational structure

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[18]High Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

[19]Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-101, March 18, 1998).

built around taxpayer needs, (2) balanced performance measures, and (3) new technology.

Organizational Structure Built Around Taxpayer Needs

IRS currently has three separate kinds of organizations, spread over 43 organizational units, that use several separate computer systems to support their activities. Under the Commissioner's proposed changes, IRS would be reorganized into four units, each serving a different group of taxpayers: (1) wage earners, (2) sole proprietors and other small businesses, (3) large corporations, and (4) tax-exempt entities. Under the proposal, each group of taxpayers would be the complete responsibility of a business center, from the processing of returns to collecting delinquent taxes. The Commissioner's proposal is based on the belief that different groups of taxpayers need very different types of assistance and programs to be compliant and that tax administration needs to recognize this to meet those needs.

While the implementing details of his proposal are not yet in place and, consequently, we have not evaluated the proposal in detail, this would appear to make sound business sense. If implemented, an organizational focus on taxpayers could bring together different functions such as customer service and collections to target those taxpayers that are noncompliant and better ensure that IRS is treating compliant taxpayers fairly.

Balanced Measures of Performance

The Commissioner's plan emphasizes the importance of having measures of organizational performance that balance customer satisfaction, business results, employee satisfaction, and productivity. The intent is to provide incentives for service-oriented, as opposed to inappropriate, behavior toward taxpayers, which is in line with the plan's overriding concept. As IRS refines its performance measures, getting stakeholder involvement is important. Stakeholders, including the Congress, the executive branch, and other interested parties, could help IRS as it devises performance measures. Conceived in this way, the measures would enhance IRS' ability to make informed decisions about how to allocate its resources between the competing demands of taxpayer assistance and enforcement.

New Technology

The Commissioner's plan notes that a key factor limiting IRS' ability to modernize its business practices is the extent of deficiencies that exist in IRS' computer systems, which significantly impact the ability of these systems to support IRS' mission and goals. The plan points out, however, that the new business practices and organizational structure provide a basis for completing and implementing the modern systems outlined in IRS' recently issued technology modernization blueprint.

As we have reported many times, existing IRS systems do not provide ready access to needed information and, consequently, do not adequately support modern work processes. Modernized systems would significantly assist IRS in carrying out its mission. However, it is important to note that the systems architecture and sequencing plan outlined in the modernization blueprint issued by IRS in May 1997 was premised on the agency's concept of business operations and related business requirements that existed at that time. To the extent that the Commissioner's organizational restructuring alters these business operations and functions, the architecture and sequencing plan may need to be modified.

Moreover, as we reported in February 1998,[20] the modernization blueprint's business requirements, systems architecture, and sequencing plan have yet to be validated using defined, implemented systems life cycle processes. Such validation is essential to ensure that IRS' modernization plans are complete and correct. In light of the Commissioner's planned restructuring of the agency, the need for such validation of the blueprint is even more acute. Therefore, we reiterate our recommendation that IRS validate the business requirements, architecture, and sequencing plan using the completed and implemented systems life cycle processes.

Longstanding Financial Management Issues Must Still Be Addressed

The Commissioner has brought in the consulting firm of Booz, Allen, & Hamilton to validate the concept of his proposed restructuring plan in terms of risk, cost and impact on customers, both external and internal. However, it is important to note that a key to the IRS' ability to effectively carry out its mission is sound financial management. This requires strong financial management systems and internal controls to ensure that information used in decisionmaking is routinely available and is reliable. This holds true under IRS' existing structure as well as the focus and structure of the organization as envisioned in the Commissioner's plan. Consequently, for the Commissioner's restructuring plan to be successful, it is critical that the longstanding internal control and systems weaknesses we have identified in our audits, as well as the new issues identified during our fiscal year 1997 audit, be fully addressed and corrected. It is only through such actions that IRS will be able to routinely and timely produce reliable information necessary to fulfill its mission. This will prove to be a significant challenge for IRS, as many of these issues are complex and do not lend themselves to short-term solutions.

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[20]Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, February 24, 1998).

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Our hope is that the business goals of the new IRS Commissioner coupled with continued Congressional oversight will change the agency culture to recognize the critical importance of resolving IRS' financial management issues. Commissioner Rossotti recently testified that IRS has a new focus and fundamental commitment to customer service, and his proposed plan to restructure the IRS emphasizes this new focus and commitment. However, IRS cannot achieve excellence in customer service without lasting improvements in its financial management. We look forward to continuing to work with the IRS on long-term solutions to these problems.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

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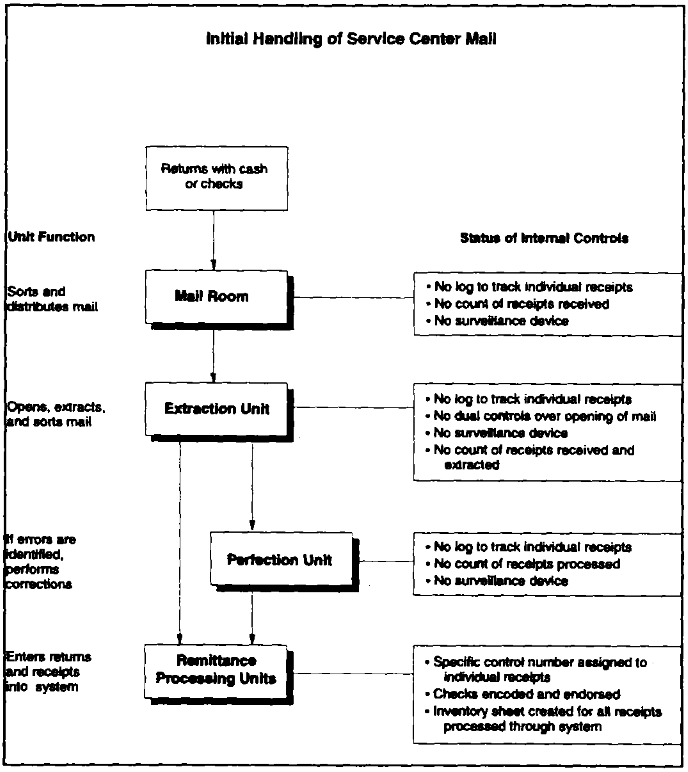
Initial Handling of Service Center Mail
Returns with cash or checks
Unit Function
Status of Internal Controls
Sorts and distributes mail
Mail Room
• No log to track individual receipts
• No count of receipts received
• No surveillance device
Opens, extracts, and sorts mail
Extraction Unit
• No log to track individual receipts
• No dual controls over opening of mail
• No surveillance device
• No count of receipts received and extracted
If errors are identified, performs corrections
Perfection Unit
• No log to track individual receipts
• No count of receipts processed
• No surveillance device
Enters returns and receipts into system
Remittance Processing Units
• Specific control number assigned to individual receipts
• Checks encoded and endorsed
• Inventory sheet created for all receipts processed through system

Mr. HORN. Well, let me ask Mr. Musick. Having heard, and read I am sure, the GAO analysis here, do you have anything you would like to contribute to the record to broaden our understanding of this? And, we appreciate very much your coming back for this.

Mr. MUSICK. Thank you. Not really. I think what I would say to you is that I agree with what GAO has to say. The difficulty that the IRS has had in the past, and I have tried to encourage the auditors and the folks in the IRS, is that we had to take a two-pronged approach to this. We had to figure out a way that we could extract data so it could be audited and the numbers could be reliable. I think we are at that point now. The difficulty is that the Commissioner has recognized, and Mr. Dodaro and others have recognized, that we are talking about modernizing a tax system to do things that it was never designed to do, and if we can't get the numbers reliable, then there is no need to continue to do an audit until this modernization is done, because there is just no way we could figure out how to do that.

So I think it is important to understand that we are at the first step here, and we need to get the numbers correct and say that the numbers are reliable, but I agree with everything that has been said by Mr. Dodaro. The systems need to be modernized; they need to capture detailed transaction data; there needs to be an audit trail when that data comes into the system and back to the master file.

Mr. HORN. You heard the exchange Mr. Kucinich had on computer security and I had one on non-computer security. Do you have any words of wisdom based on other governmental experiences as to how these two problems can be solved?

Mr. DODARO. The problems that IRS experienced, as I was here a couple of weeks ago talking about governmentwide computer security issues, are very similar at other agencies, both in physical security as well as in the computer security area. We have made literally hundreds of recommendations to IRS, and they are about halfway through implementing many of our recommendations. They are beginning to get a handle on the physical security as well.

A big problem that has been highlighted in the computer security that the financial audits have spotlighted has been the issue of browsing taxpayer files. That issue of unauthorized access by current IRS employees has been a particular problem area that they need to get control over, and we will also be doing some penetration testing of IRS's vulnerability to intrusion by outside computer hackers, as Congressman Kucinich mentioned. But they have a good road map. We certainly have provided them with a number of recommendations, and they do finally have an organizational structure focused on security, which has been one of our big recommendations that has been outstanding for a number of years. They have filled that hole and now they are filling in all the detail. But it is going to take a considerable amount of work. Also, it is very important to address the computer security area in the modernization blueprint, they have a well-defined security architecture. That is one of the things they haven't outlined yet, but I know the Commissioner is committed to do that.

Mr. HORN. Now, all of the rest of you from GAO listened to the exchange between the Commissioner, the former Chief Financial

Officer. Ms. Willis, do you have any thoughts, given your area of jurisdiction, which is Director of Tax Policy and Administration Issues in the General Government Division?

Ms. WILLIS. Mr. Chairman, what I would emphasize is a point that Mr. Dodaro made, and that is successful restructuring of IRS on a programmatic level, as well as the ability of GAO, the Congress, and the American public to do oversight and to understand IRS programs is dependent on IRS fixing its financial systems. We need to have good quality, timely data to be able to understand why problems are occurring and how to fix those problems. Frequently within IRS the problem cannot be fixed where it occurs, but it has to be fixed much, much farther upstream in the process. Right now we frequently don't have the data that would allow us to decompose a problem and resolve it and prevent it from happening systemically. So until these systems are fixed, we are going to be handicapped.

Mr. HORN. Mr. Kutz, you are Associate Director for Governmentwide Accounting and Financial Management in the Accounting and Information Management Division of the General Accounting Office. Would you respond to what you have heard the Commissioner say, the Chief Financial Officer say?

Mr. KUTZ. Mr. Chairman, I would like to make a couple of observations on the unpaid assessment chart that Mr. Dodaro spoke about. We talked to Mr. Musick about this several times, the composition of the pieces of the pie that you see up there.

One important observation I would make overall is that the IRS does not choose the customers essentially that are included in the inventory of unpaid assessments. By definition the folks in there are bad credit for the most part. We looked at a sample of 730 different items, and Mr. Sebastian and I looked at every one of those together between us, and we found some very interesting insights that help explain why the IRS is only able to collect 13 cents on the dollar. We can get into some of that in detail if you would like.

Mr. HORN. I would like it, because I will tell you, as the average taxpayer, including this average taxpayer, takes a look—as I did several years ago, that I mentioned earlier—at where over $100 billion had been written-off essentially since 1990, and where there was another pot where they said oh, we can collect the other about $64 billion, and I think your chart well shows that it is a little bit of dreaming to think that you will get that much money out of this. You might want to explain that in some detail so we all understand it.

Mr. KUTZ. All right, let me go through a couple of the different pieces of pie. I have some details with me to walk you through that. First of all, with regard to the amounts considered collectible, the $28 billion, I will give you some of the details of what we saw in our sample of 730. We saw 80 cases in there of the 192 that had some collectibility that were installment agreements. These installment agreements were primarily with individuals, businesses, and there were also some estates.

Of these 80 items, 16 were estate cases that were generally 100 percent collectible; 61 of the cases were individuals that had entered into installment agreements with the IRS, and the other 3 represented corporations. We saw some or all of these cases as being collectible.

We saw 36 cases in our sample where the taxpayer had, subsequent to our sample pull, actually paid in full or in part the taxes that were owed. Of course, we considered those cases to be collectible, since the money was in the door.

We saw 17 cases where the taxpayer had a history of allowing the IRS to do a refund offset, where in the current year the taxpayers had a refund due and the IRS offset that refund against the past taxes due. So we projected refund offsets forward for the cases and found some collectibility there.

The final area where we saw some significant collectibility was for taxpayers that had a recent history of compliance. Established corporations were 10 of them were very large established corporations, and other individuals that were having a history of compliance. So that was what I saw in, and Mr. Sebastian and I saw, in that sliver with the $28 billion.

Let me give you a couple of details in the other piece, the uncollectible tax receivable. This is quite interesting. There were 267 taxes receivable items we found that had no collectibility. Of these 267, we saw 75 that were considered hardship cases by the IRS, where the IRS had deemed that the taxpayer had insufficient revenue or assets to pay the taxes and thus was not pursuing collection.

We saw 41 instances of the trust fund recovery penalties—which has been mentioned several times today—where individual officers had been assessed the amounts that the corporations owed, and that we considered in our sample to be uncollectible. We did not see evidence of money coming in the door for those. We saw 21 individuals that were in bankruptcy, and we saw 15 sample items where the assessments resulted from illegal acts. These were high dollar cases and the individuals were often in prison. Some of these illegal acts, which are taxable and involve multiple penalties, included drug trafficking, embezzlement, prostitution, international arms dealers, real estate fraud and other tax fraud. So, again, this is something that is a little bit different than your normal private sector accounts receivable.

We also found 10 sample items where the IRS could not locate the taxpayer. These details give you a flavor of the different components of the $62 billion and the $28 billion that made up the taxes receivable.

Mr. HORN. Thank you. I now yield 10 minutes to the gentleman from Ohio, Mr. Kucinich.

Mr. KUCINICH. Thank you very much, Mr. Chairman. I would like to continue with Mr. Kutz's observations here, and get into a more detailed discussion of the testimony where you talk about components of IRS's $214 billion of unpaid assessments in the pie chart represented here.

Let's go around this pie chart again.

Mr. KUTZ. OK.

Mr. KUCINICH. First of all, $76 billion in write-offs.

Mr. KUTZ. Yes.

Mr. KUCINICH. In plain language, what does it mean when you write off a debt?

Mr. KUTZ. In the private sector it means you write it off the books. In this case, the IRS is required to keep writeoffs on the books for 10 or more years by statute. So IRS is keeping writeoffs on the books. Write-offs is basically something that is uncollectible, but because of the requirement to keep it on the books, it is still there.

As Gene mentioned, there are FDIC and RTC cases in writeoffs that have absolutely no hope of collection. For the most part, 148 or so of the sample items we saw were corporations that had been defunct, most of them had been defunct since the late 1980's.

Mr. KUCINICH. For example, if a corporation becomes defunct, do you track if the incorporators go back into business and start a new company? Do you ever pursue those individuals for the back taxes, or if they go in as incorporated, is it simply uncollectible and you don't go after the individuals?

Mr. KUTZ. Are you talking about the trust fund recovery penalties you talked about earlier with the IRS folks?

Mr. KUCINICH. Right.

Mr. KUTZ. We did see a number of instances where individuals who owned these corporations had multiple corporations that had defaulted on their payroll taxes. We saw one case where there were eight different modules that were outstanding from three different corporations for one individual. We saw a number of other cases where an individual business owner had several payroll taxes that were outstanding for different corporations.

So as the IRS had said earlier, they kind of move around and start up businesses and then they don't pay their taxes. So there are multiple offenders.

Mr. KUCINICH. For some people it is a way of doing business.

Mr. KUTZ. It appears so, yes.

Mr. KUCINICH. How widespread is it? Can you put numbers on it in terms of the number of cases?

Mr. SEBASTIAN. There were 83 cases involving trust fund recovery penalties, in 17 of these cases which we saw officers in essence withholding the payroll taxes multiple times, talking 17 of 83 cases that we reviewed.

Mr. KUCINICH. What happens when payroll taxes aren't paid? What typically happens in those cases? Who is liable?

Mr. KUTZ. The corporation, of course, is liable, but the IRS is also able to assess officers for the unpaid amounts withheld from individuals for Social Security, hospital insurance and individual withholdings. So there are multiple assessments that are outstanding with the business and the officers of the corporation. That is one of the things. The initial pie that we had was $236 billion. The reason that the pie is $214 billion is that there were duplicate assessments in the IRS system that we wrote off as part of our audit. That related primarily to the trust fund recovery penalties. So the IRS can really only collect the money once, but it was on the books in some instances 4 or 5 times.

Mr. DODARO. The other important note here is a lot of what is in that pie chart are interest and penalties that keep accruing on old debt. Some of the debt, and the write-offs, for example, goes back to the late 1980's, 1990 timeframe. Indeed of the total of the $214 billion assessments, about $136 billion of that are interest and penalties, and not the original debt or the taxes that are assessed. So the growth in this unpaid assessments category is largely driven by the interest and penalties.

Mr. KUCINICH. So in putting a dollar amount, that figure of $76 billion in write-offs would be corrected to about $30 billion then, is that correct?

Mr. DODARO. If you eliminated the interest and penalties.

Mr. KUTZ. That is a fair assessment.

Mr. KUCINICH. It is still a significant amount of money. To go back into it, who makes the decision as to whether a debt is written off or not?

Mr. DODARO. Basically, in this case, the absolute term of a write-off, in the sense that it is not pursued any more is governed by the legal statute of 10 years. Once that 10-year period has elapsed, IRS decides what to do at that point, at that point. What we are doing, working with IRS to prepare the financial statements and then to do the audit, is to provide a financial accounting of exactly what the nature of this inventory is, and what can be realistically expected to be received. So the terminologies we are using here are imbedded in the new accounting standards that have been put in place to make sure that the decisionmakers and the Congress and IRS have accurate information.

There has been a litany of assumptions made in the past years that the large part of this inventory would be actually collectible, and there have been pursuits to try to do that. The big point I would emphasize, which is very similar to what the Commissioner emphasized here, is that there has to be earlier identification and collection. A lot of these cases in here are several years old, where people can't be located, where there has been failures of the corporation, and basically IRS's ability to collect that old debt diminishes as time elapses. IRS needs better information so it can age these and then attack the ones that are most recent.

Mr. KUCINICH. There is a point at which you pursue legal action to collect, right? You go to court, you file liens?

Mr. KUTZ. Correct. Most of these corporations that are in the $76 billion have been through bankruptcy court and now they are defunct. There is nothing left to get. These amounts are completely uncollectible.

Mr. KUCINICH. Fine. But, you know, you have explained that. The question I have though is that if you filed some legal process, the names of the corporations become public record, correct?

Mr. KUTZ. I can't answer that question.

Mr. KUCINICH. Does it?

Mr. DODARO. I would have to check. Do we have attorneys with us?

Mr. KUCINICH. I think it comes to this, if there are corporations who are avoiding paying millions of dollars in taxes, and they avoid all of the processes that you use to try to collect, is there any way that these corporations can be made known publicly, that the principals can be made known? So we can see if they are trying to do business with the government again? If we are setting them up in business or anything like that? Is there any way to know? You don't know?

Mr. MUSICK. I don't know if I can answer that question, but let me just clarify something, because I am not too sure that this is a collection issue. What they have defined here is——

Mr. KUCINICH. Excuse me, I understand. Let's say that I understand it is not a collection issue, but it is an issue of accountability for the people, even though you can't collect the debts. I understand that. You have well established there are debts you cannot collect. What I am asking is coming from a different direction.

Who are these people who beat the taxpayers out of billions of dollars? Or millions in some cases, and can we find out? Is there a list of corporations available? Can we find out? We can stop these people from doing it all over again and stiffing the taxpayers and maybe getting government contracts and becoming a wealthy person at the expense of the taxpayers on the one hand with government resources, and on the other hand not paying their taxes? How do we stop this?

Ms. WILLIS. Congressman, under section 6103 of the Internal Revenue Code, that information cannot be released. It is protected as taxpayer data and the fact that someone, a taxpayer, be that a corporation or an individual, owes the government tax dollars is protected information.

Now, if it goes into a bankruptcy court where there is a public record, where this is an outstanding liability, you have more information available. But right now as the statute is written that information is protected.

Mr. KUCINICH. I am all for privacy. I think privacy is a fundamental American right. But we are talking here about 10 years past collection, uncollectible debts. Do you keep a list of people who have gone into bankruptcy where the name becomes public?

Ms. WILLIS. No. I am saying the Internal Revenue Code would have to be changed to allow this information to be made public.

Mr. KUCINICH. Mr. Chairman, you know, it may be that since we have identified an area of vulnerability here, and we have identified that there is a scam, one of many scams that goes on as a way of trying to avoid paying taxes, then this might be a relevant area to look at the code, to find out if after a certain period of time people haven't paid, it is uncollectible, if that information then becomes public.

I mean, if people don't pay their real estate taxes back in counties across the country, their name can be printed by the county auditor in the newspaper for a couple hundred bucks. And yet someone can claim a sacrosanct privacy if 10 years later they stiff the government for millions? I don't think so. If it is that way, I think this might be an opportunity for us to look at the code and to change it. We need to know who these people are, so they aren't doing it to us again.

Mr. HORN. I completely agree with the gentleman. In the Debt Collection Act, which we authored and became law 2 years ago, we had to leave out the IRS because it is under the jurisdiction of the Committee on Ways and Means.

Now, doing that—and that is where the privacy thing came from—I am sure was in good faith. But the fact is, if you got them under the Debt Collection Act, every time they applied for a government benefit, that would now be caught and they wouldn't get that government benefit if they owed the government money.

That is what started us in this debt collection effort. When we saw what IRS had written-off under the previous administration of IRS, and I am talking pre-Commissioner Rossotti, I thought it was a national scandal. But apparently some committees here don't, and we are just going to have to urge them again.

Some of that got back to the pilot program in IRS on debt collection, and I wonder if you could tell us what you know about that. The last I knew, Mr. Kolbe's subcommittee on appropriations, that has jurisdiction over their funding, mandated on behalf of myself and Ms. Johnson of Connecticut, who heads the Oversight Committee on Ways and Means, that there would be a pilot project. As I remember, one bundle of the pilot project which I thought was an absolute phony by IRS was 5-year-old debt. You have got to start in the first 30 days, as I have been saying, 30, 50, 60, whatever, and followup, and not let it age, as the point was made, so that they think it is a grant. It is unbelievable. They just think, oh, well, nobody cares, why should I pay it?

Well, it means you better get a decent collection effort. And it means IRS has its role to do it in 30 days, I would say, maybe 60 at the most, and then turn it over to private collectors. I listened to a lot of nonsense from the previous administration of the IRS that that would affect a privacy law.

I said look, as I said earlier today, just give them the address and what they owe the taxpayers of the United States.

Mr. DODARO. There were a lot of problems with that pilot, Mr. Chairman. I am going to ask Ms. Willis to explain that. She has been doing in-depth analysis of the pilot since its inception.

Ms. WILLIS. Mr. Chairman, basically the Congress appropriated money for three pilots at IRS, only one of which was ever started. And as we got into that pilot, we recommended, with the agreement of the IRS Commissioner, that that pilot be stopped because it was running into a variety of problems from a systems perspective, a legal perspective, and an operational perspective. We have since gone in and looked at the pilot, briefed you and Chairman Kolbe and Chairman Johnson on that pilot, which was very limited. One of the restrictions placed around the pilot was that they could only pilot the collection of debt by private parties that IRS otherwise would not be working with. So these tended to be older accounts. They also tended to be smaller accounts.

Since that time, we have been charged with working with IRS to redesign a pilot, and basically, based on our look at IRS systems and working with the new Commissioner, we have come to the conclusion that until some of the basic problems with IRS's processes are fixed, it is going to be very difficult to design a pilot that will tell us anything about the use of private debt collectors that we can take forward in terms of putting firm programs into place.

Let me point out one of the issues that is very, very critical, and it gets back to the timeliness problem. Right now a big part of the problem with the debt is not how long it has been delinquent, but how long it took IRS to actually assess the additional tax after the tax return was filed. So that by the time the taxpayer is aware they owe additional tax, a substantial period of time has passed, sometimes 2 to 3 years, and at that point there is interest, there are penalties, and there is a great deal more money owed than there would have been had it been assessed earlier in the process.

Shortening that assessment timeframe is critical to resolving the collection problems that the private debt collectors faced in this pilot. There has to be recent tax year debt that has gone out for collection soon after being declared delinquent as well. There are ways to shorten all of those processes, but they are going to require major reengineering efforts.

Mr. HORN. Did the GAO review Commissioner Rossotti's plan for restructuring IRS?

Mr. DODARO. We have taken a look at it. At this point, as you know, it is a high level concept statement, and we are, like a lot of other people, awaiting additional details. We will take a closer look at it as the specifications become more available. But as a general proposition, as I mentioned, it has a lot of merit in terms of realigning by different types of the taxpayer.

Mr. HORN. I do, too. I wanted to pick up on Ms. Willis' point. Was GAO satisfied, in the assessment of certain taxpayer's filings, that the debt collection apparatus is apparently hinging on the time it takes to record that assessment? And if they procrastinate, I am not saying anybody is doing anything evil, I am just saying their system may not be geared now to record the assessment quickly. It seems to me, in the Commissioner's restructuring, that is a very basic point for him to deal with.

Is that correct, Ms. Willis?

Ms. WILLIS. That is correct. And it is also a point that he recognizes and a point that is critical around the structuring of the system to address groups of taxpayers. Part of the reason that that issue has not been addressed to date is the functional nature of IRS's organization. The people in collections have never had any accountability or responsibility for the assessment process and vice versa. The fact that it took this long to assess was not in any way reflected in the returns processing or the exam functions performance measures. It became a problem for collections.

So if we have a structure that is built around different categories of taxpayers, properly implemented, what it should allow us to do is go in and look at where the problems are occurring—and it does vary by type of taxpayer—and design strategies for intervention to prevent problems as well as to get the taxes assessed more quickly, design the specific systems to do that, and to resolve the problems that end up right now sitting in collections.

Mr. DODARO. The other aspect of that, Mr. Chairman, is the modernization blueprint that the Commissioner mentioned. That is in its high level descriptions, but as it moves on you need to define the business requirements and have those validated so they will support the new restructuring proposal. It is really paramount that it gets done properly. We have made recommendations, which the Commissioner has agreed to implement, to do that as the specifics of the restructuring proposals unfold.

Mr. HORN. Mr. Musick, is there anything you can enlighten us with about the collection pilots that occurred? I believe you were Chief Financial Officer then.

Mr. MUSICK. Yes, but that really comes under Mr. Dalrymple's area, who left. It was under the collection function. Really, my dealing with collection data is to get into what the data is when we pulled it out for the financial audit. I think what GAO has identified here and is just a simple change in wording to the words "unpaid assessments." We used to call that accounts receivable dollar inventory, and everybody focused on the words "accounts receivable." It really isn't accounts receivable as we would think of it.

[The information referred to follows:]

The Internal Revenue Service (IRS), as a pilot agency under the CFOs Act of 1990, has prepared financial statements and subjected them to audit since 1991. Initially, the IRS received disclaimers of opinion on its financial statements from the General Accounting Office because its records were not suitable for audit. The IRS undertook substantial efforts to improve the quality of its records and was recently rewarded through the receipt of an unqualified opinion from the GAO on its 1997 financial statements. This is a substantial achievement. The revenue of the Federal Government has now been audited and this is a giant step toward the Administration's goal of obtaining an unqualified opinion on the consolidated financial statements.

However, the GAO found that IRS accounting systems are not sufficient for a timely accounting of amounts due to the government. Nevertheless, actions taken by the IRS to improve receivable records in response to the audit of prior year financial statements are credited with an increase in collections of delinquent taxes. While the ultimate solution to the receivable issue rests in systems modernization, a long-term initiative, the IRS has stated its commitment to remedial efforts to address the issue to the extent practicable. Given the IRS's accomplishment for 1997, its commitment to resolving this matter is not in question.

Mr. HORN. I wanted to thank you for coming back and sharing some of those insights with us. The staff on both the Democratic and the Republican side will have a few questions to submit to this panel. If you would, you are still under oath, give us as succinct an answer as you can. We would like to put them in the record at this point without objection.

I am particularly pleased that both GAO and IRS were able to connect this year, and they got a favorable opinion, and that is important. In 1993, when a lot of us on this committee looked at this situation, we said there are two agencies for sure we knew in 1998 that wouldn't make it. One was the Department of Defense and the other was IRS. Well, you surprised us. IRS made it, and I am sure that is thanks to you and a lot of people, Art Gross, the Chief Information Officer, and others over there. The Department of Defense, we will be dealing with tomorrow morning.

So, in other words, DOD has had 2 years to try and match the $25 billion up with acquisition and inventory. We will have that session tomorrow. I don't know if GAO is coming. I think you are.

Mr. DODARO. I will be here tomorrow, Mr. Chairman.

Mr. HORN. You are always looking for $25 billion, wherever you can find it. So are we. But, if you have no other comments you want to make on Mr. Rossotti's statement, as far as I am concerned, we can move to the next panel. We again thank you all for coming and we appreciate the excellent advice you have given us.

[NOTE.—The GAO report entitled, "Financial Audit—Examination of IRS' Fiscal Year 1997 Custodial Financial Statements," may be found in subcommittee files.]

Mr. HORN. We now have panel III, Mr. Stefan Tucker, the chairman-elect, Section on Taxation, American Bar Association, and we have Mr. Michael Mares, the chair of the Tax Executive Committee, American Institute of Certified Public Accountants, and we have Mr. Thomas H. Stanton, chair, Standing Panel on Executive Organization and Management, National Academy of Public Administration, and Mr. Stanton will be accompanied by Mr. Herbert N. Jasper, member, Standing Panel on Executive Organization and Management, National Academy of Public Administration.

Gentleman, you know the routine.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all four witnesses have affirmed. We will just go down the line in the order they are on the agenda. Mr. Stefan Tucker, chairman-elect, Section on Taxation, American Bar Association is first.

STATEMENTS OF STEFAN TUCKER, CHAIRMAN-ELECT, SECTION ON TAXATION, AMERICAN BAR ASSOCIATION; MICHAEL E. MARES, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS; AND THOMAS H. STANTON, CHAIR, STANDING PANEL ON EXECUTIVE ORGANIZATION AND MANAGEMENT, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, ACCOMPANIED BY HERBERT N. JASPER, MEMBER, STANDING PANEL ON EXECUTIVE ORGANIZATION AND MANAGEMENT, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

Mr. TUCKER. Thank you, Mr. Chairman. I am presenting my testimony today on behalf of the ABA Section on Taxation, which is the national representative of the legal profession with regard to our tax system. We appreciate the opportunity to appear before your subcommittee today to discuss various proposals to restructure and reform the IRS.

Perhaps no committee is as attuned to the need for reform of the IRS than this committee, and we concur with your views as to the possibility of success under Commissioner Rossotti. We have a great deal of confidence that with his background and his ability, both to focus on the organization and the systems, and quite frankly, to think outside the envelope, that he will be successful.

We think he needs a lot of help from Congress in terms of doing this, and we are pleased that your committee is focusing on this.

We have been privileged on a number of occasions to work with the Commission on Restructuring the Internal Revenue Service, the members and staffs of the tax writing committees, and the representatives of both the Service and the Treasury as they developed first the Commission's report and then the House and Senate bills. We believe that a lot of thought has gone into this process and we think a number of the conclusions of the committee are quite important.

The first thing we would like to focus on is governance and oversight. We recognize that both the House and the Senate bills would create an IRS oversight board to handle the oversight of the Internal Revenue Service's administration, management, conduct, direction, and supervision of the execution and application of the tax laws, and we were pleased to hear Commissioner Rossotti say that he in turn is pleased with the Senate version of that bill.

We are pleased that the Senate version includes a sunset provision. That was something we recommended in the Senate Finance Committee hearings. We are pleased that the Finance Committee has focused on that sunset provision. Our concern still remains the fact that a board that has management functions rather than oversight functions could itself be an impediment rather than an aid to better management. We think that there is a necessity for a board. We think that a board ought to be a board of oversight with its sunset provision in place and it ought not to be an impediment to the proper functioning of the Internal Revenue Service.

We recognize in many respects that what is there is broken has to be repaired and in many respects not merely repaired, because that implies simply replacing a few shingles in the roof. We think maybe you have to replace the whole roof in some aspects. We think this board of oversight can help do that, and be in many respects a reporting board to the Congress.

We think that if the board were responsible for issuing annual reports or even semiannual reports, which probably would be better, that those independent reports from an independent board would be very, very useful to the Congress in its oversight, and this subcommittee should be very concerned about oversight and reform, because this subcommittee is a part of that particular committee of the House.

We think that the board can accomplish this. Quite frankly, we believe the board ought to be comprised only of independent sector members. We recognize that the Senate Finance Committee has focused on adding both a union representative and the Secretary of the Treasury. We think the board ought to be an independent board, and that is in our written testimony.

We think you are going to have very high caliber members on the board. This is going to be something that people will look at as both a burden and as an opportunity to help the American system, and we think you will be able to attract those people.

In turn, even though the Senate Finance Committee would give only limited authority to the board under section 6103, which is a privacy provision, we think that is probably not beneficial. If this truly is a private board, the ability to micromanage and to interfere and to be an impediment is something we ought not to be having.

We noted that you read our written testimony in advance, and we appreciate it. We noted you had a question as to the need for an Under Secretary of the Treasury. I would like everybody to think outside the envelope and not inside the envelope. The Treasury Department clearly has had oversight of the Internal Revenue Service historically. Historically, it hasn't worked. Historically, the Secretary of the Treasury has many, many more burdens and many, many more responsibilities.

In an international economy, fiscal responsibility, both internationally and domestically, you need somebody at the Treasury who has direct oversight on behalf of the Treasury for the Internal Revenue Service. In the absence of a designated Under Secretary of the Treasury, at best that would be sporadic. At worst that will be nonexistent. No matter how often we think of it, we think reform and oversight at the Treasury level is required here, even with the independent board, even with the many committees of Congress who have their oversight of the Internal Revenue Service. You need a person who has that responsibility and we strongly believe that that is a necessary responsibility.

We applaud the Commissioner's views on personnel. We strongly believe the Internal Revenue Service needs flexibility to hire the best and the brightest, and we would encourage that we think outside of that envelope as well. Civil service has its place, but it does have its own constraints.

We would come back to tax simplification. One of the problems that the Internal Revenue Service has is responding to the many, many acts of Congress in terms of changing the Internal Revenue Code. During the 1980's, there was at least one act every year. During the 1990's, we have had major overhauls. The more complexity Congress piles on the Internal Revenue Service, the harder it is for their personnel to deal with the Internal Revenue laws and the regulations. It is very hard for us, and we are tax professionals on the AICPA level and the ABA Section on Taxation level, to deal with all of this, both the guidance and absence of guidance.

We would urge you to focus on the need for simplification, real simplification and what Congress in turn does to the IRS, which is a whipping boy for the American public. Thank you. I see my time is up.

[The prepared statement of Mr. Tucker follows:]

Mr. Chairman and Members of the Subcommittee:

My name is Stefan F. Tucker. I appear before you today in my capacity as Chair-Elect of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation, which is the national representative of the legal professions with regard to the tax system. This testimony has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

The Section appreciates the opportunity to appear before the Subcommittee today to discuss various proposals to restructure and reform the Internal Revenue Service. Our testimony focuses principally on issues of governance of the Internal Revenue Service (hereafter, "Service" or "IRS"), tax simplification, Congressional oversight of the Service, IRS budgets, and certain other proposals.

We were privileged to consult on a number of occasions with the Commission on Restructuring the Internal Revenue Service, members and staffs of the tax-writing Committees, and representatives of the IRS and Treasury as they developed, first, the Commission's Report and then the House and Senate Bills.

We believe the Commission Report identified crucial issues regarding the management of the Service and attempted to deal constructively with those issues. While the Section does not agree with all of the solutions proposed by the Commission or the House Ways and Means and Senate Finance Committees, we believe the thoughtful way in which the issues have been presented will certainly aid in the design of a workable solution. We also have been impressed with the attention to IRS management issues given by Secretary Rubin and others within the Treasury Department, and we anticipate that their efforts likewise will be productive. Furthermore, of course, we hope that the testimony which we present today contributes to the goal of a better tax system for our country.

As a preliminary matter, the Section of Taxation wishes to emphasize and forcefully endorse the conclusions reached by the Commission on the relationship between the complexity of the tax law and the difficulty of tax administration. As we will discuss in greater detail, there is little question that many of the perceived failures of the Service are closely linked to the complexities in the Internal Revenue Code that have occurred on a geometric basis over the past seventeen years. Unless there are meaningful legislative and administrative efforts to simplify the tax law, any changes in IRS governance that may result from the Committee's efforts will lose their effectiveness.

I. GOVERNANCE AND OVERSIGHT

1. Governance

The House and Senate Bills would create an IRS Oversight Board (the "Board) within the Treasury Department. The Board would be charged with oversight of IRS "administration, management, conduct, direction, and supervision of the execution and application of" the tax laws. Specifically, the Board would have the authority to: (i) review and approve IRS strategic plans; (ii) review operational functions of the IRS; (iii) provide for review of the Commissioner's selection, evaluation and compensation of senior managers; and (iv) review and approve the Commissioner's plans for major reorganizations.

a. Board of Oversight

The Tax Section is concerned with the proposal in both Bills to vest in the Board direct approval authority over certain functions of the IRS. We believe that the President has, and should continue to exercise, the ultimate authority over the IRS. Management of the agency charged with collection of virtually all of the revenues of the Federal Government is, fundamentally, an Executive Branch function. We believe that this is consistent with both the Constitutional notion of separation of powers and the management notion of accountability.

Moreover, we believe it is impossible, as well as unwise, to split the fiscal management of the Service from other issues involving tax administration, enforcement and policy. These functions should be retained by the only branch of government capable of carrying out both simultaneously -- the Executive Branch -- and should continue to be lodged in the Treasury Department, the Cabinet department charged with administering the Government's fiscal affairs.

We are concerned that a Board with substantive authority over IRS operations could be an impediment, rather than an aid, to better management. Much of the criticism directed at the Service in recent months, at its core, has been about lack of control and accountability. The Service is a huge organization which, like most bureaucracies, tends to function with or without top-down leadership. Any restructuring proposal should seek, as its principal goal, further to enable those in charge to control the agency.

An independent board of oversight with management authority actually may hinder, rather than enhance, management accountability. Instead of a single head, operating within the Treasury chain of command, there would be separate power centers, each competing for its share of authority and each with different reporting relations. We see a Board with management authority as both a potential distraction to the Commissioner and, even worse, a rival. As a separate power center, the Board offers a potential for intrigue on the part of those seeking to undermine or circumvent the Commissioner. While this result is by no means a certainty, creating even the potential for such confusion is problematic. The Tax Section believes this development would run counter to the suggested goal of enhancing management of the Service.

The Section therefore urges that day-to-day management functions remain within the Treasury Department. Consequently, we do not support the proposal to shift approval of certain management decisions to the Board. By retaining all such authority within the Executive Branch, clear management accountability will be maintained.

Having said this, we believe the creation of a Board without management authority could serve a useful purpose. Consistent with our view that private sector expertise should be made available to the Service's senior management and that such individuals should be involved in the oversight process, we recommend that Congress create an IRS Board of Review, made up exclusively of private sector members. No government officials would serve on the Board, either directly or ex officio. We suggest that the size of the Board be kept relatively small; five or six members would seem optimal. Their appointment, compensation, etc. would be as proposed by the House.

The role of the Board would be specified by Congress in implementing legislation and would be somewhat similar to the role recommended by the Commission. For example, the Board would be expected to review and provide input to the Service's proposed budget, short-term and long-range strategic and operational plans, and major proposed management initiatives. In addition, the Commissioner would be expected to consult with the Board regarding the appointment, evaluation, and compensation of the Commissioner's senior management team. The Board also would be expected to recommend to the President qualified candidates for the positions of Commissioner and Chief Counsel.

A Board constituted in this way would have the duty to make periodic (probably semi-annual) independent reports concerning its assigned tasks directly to the President and the Congress. Such reports would be expected to deal in a candid and uncensored fashion with the successes and problems of the Service, as well as any management initiatives which Congress must approve. Members of the Board would be available to consult directly with, and testify before, the Congress on the successes and problems of the IRS. Rather than the Board being involved in direct management of the Service, we conceive of the Board's role as an extension of Congressional oversight. It would serve as the eyes and ears of Congress with respect to the Service. The Board would be directly involved in reviewing the major management decisions affecting the Service without disrupting the normal Executive Branch authority.

Some might argue that a Board constituted in this manner would lack any authority. We clearly disagree. The strength of the Board's authority would have would come not from direct management responsibility, but from its reporting responsibility to Congress. The Board would have a direct link to the Congress that could not be circumvented by IRS or Treasury management personnel. As a result, such management personnel would, in all likelihood, seek to work with and accommodate the Board.

Importantly, the Board would contribute the relevant expertise of private sector professionals as a consultative resource for the IRS and the Treasury on major management matters. This role should be specified in implementing legislation. A properly recruited Board could make considerable resources available to the IRS and could complement the management skills of the Commissioner by making available expertise in areas with which the Commissioner may be less familiar.

We are convinced that a Board of Review, operating as we propose, would attract very high caliber members from the private sector. We are confident that these individuals would add substantial value to the analysis and review of management issues, and Congress would view the Board's role as an adjunct to its oversight responsibility. Because of the important impact such Board will perforce have on improved management and oversight of the Service, we think there will be no shortage of top quality private sector individuals willing to serve.

b. Congress should establish the position of Undersecretary of Taxation

We concur in the assessment that Treasury oversight of the Service has been "limited and uncoordinated". We are concerned, however, that neither the House nor the Senate Bills would improve that Treasury oversight function. Therefore, we propose that this problem be addressed directly by creating within the Treasury Department a new Undersecretary of Taxation. The Undersecretary would be charged specifically with that responsibility, together with the task of coordinating the entire tax system, both tax administration and tax policy. The scope and importance of this new position dictate that it should be filled only with an individual having significant experience with the tax system.

The Undersecretary would report directly to the Secretary. In addition, the Undersecretary would be required to assure Treasury's participation with the Commissioner and other IRS management in the development of long-range planning for the Service. The Commissioner and the Assistant Secretary of the Treasury for Tax Policy would report directly to the Undersecretary. The Chief Counsel of the Internal Revenue Service, who currently reports directly to the Treasury Department General Counsel and has dotted-line reporting responsibility to the Commissioner, also would have dotted-line reporting responsibility to the Undersecretary, as would the Assistant Secretary for Management and others as deemed appropriate.

We believe that creation of such a position addresses more directly than does an outside Board the concerns expressed by the Commission concerning Treasury accountability. Such a position provides a person at the highest levels of Treasury whose sole responsibility it would be to manage and coordinate the tax functions of the Administration. This is, in fact, what has been lacking in past Administrations, a point emphasized by the Commission. The Undersecretary would serve as the point of intersection between tax administration and tax policy, with the clear mandate to coordinate these functions. In turn, the Undersecretary would report directly to the Secretary, the individual charged by the President with overall responsibility for the Treasury's tax function.

The Undersecretary would be required to make periodic reports to the Secretary, who in turn would be required to report regularly to the Congress. The Undersecretary and the Commissioner would be required to attend meetings of the Board at such times as the members of the Board determine, and would be responsible for reporting to and advising the Board about impending management proposals. The Undersecretary also would be available to the relevant Congressional committees to report and consult on matters relating to the Service.

The statutorily mandated job description of the new Undersecretary that we have in mind differs from those of prior Treasury undersecretaries. For example, early in President Reagan's administration, an Undersecretary for Economic Policy had supervisory authority over the Assistant Secretary for Economic Policy and the Assistant Secretary for Tax Policy. We do not envision, and would not support, the proposed position as involving economic policy. Rather, the tasks assigned to the new Undersecretary should be limited strictly to those relating to the management of the Service and those relating to tax policy.

Creation of the position of Undersecretary of Taxation would assure clear, continuing and coordinated accountability within the Treasury Department that, to date, has been absent. This would avoid not only the prospect of management by committee, but also assure the greater coordination of fiscal management of the Service, tax administration and tax policy that we believe is essential. Together with a Board of Review reporting directly to Congress, the Undersecretary will provide a clear focus of responsibility, authority and accountability.

2. Personnel Policies

The Tax Section strongly endorses the recommendations of the Commission and the proposals in the House and Senate Bills that give the Commissioner more flexibility with respect to IRS personnel. Historically, Civil Service rules have tied the Commissioner's hands, making it extremely difficult, if not impossible, for the Commissioner to hire the best people from the private sector and pay them at appropriate levels. We believe strongly that it is not in the best interests of the tax system for such inflexibility to continue. As an agency at a crossroads, it is imperative, for the benefit of both the Service and the Congress, that the Commissioner be able to bring into government the best and the brightest. That cannot and will not happen unless flexibility in hiring is increased and unless the Commissioner is given the ability to pay such individuals at levels that will attract them away from high paying private sector jobs.

3. Independent Inspector General

The Tax Section also supports the creation of an independent Inspector General within the Service. At present, the Treasury Inspector General serves as the Inspector General for the Service as well. This relationship suffers in many ways from the same problems as that of the Service to the Treasury generally. The Treasury Inspector General is responsible for an entire Cabinet department, which make it exceptionally difficult for that person to devote as much attention as necessary to the Service. This would be rectified by the creation of an Inspector General position at the Service.

In addition, we believe that an independent Inspector General at the IRS would go far to address public perceptions about an agency out of control. While we do not share the view of some that the IRS is a "rogue" agency, recent revelations make it clear that abuses are not random or isolated, and should be dealt with accordingly. An independent Inspector General would go far to addressing those perceptions.

The Section is concerned about the proposal in the Senate Bill to eliminate the IRS Office of Chief Inspector and transfer such functions to the Treasury Inspector General's office. Our experience with the Treasury Department and IRS lead us to conclude that such a shift may actually result in less, rather than more, attention being paid to problems in the IRS. Removal of the Inspector General position from the agency does not, in and of itself, ensure greater success. Indeed, to move the function outside of the agency may result in a diversion of resources to other inspection functions. In addition, the fact the inspection function is removed from the agency may actually limit the Inspector's ability to know the culture and weed out problems. To this end, we cite the successful tenure of Frederic Hitt, Inspector General of the CIA, as evidence that an independent Inspector General within an agency is a workable model.

4. Congressional Oversight

We endorse the Commission's proposal to establish a Congressional entity to coordinate IRS oversight. A joint panel, comprised of members from the various Committees of jurisdiction, would provide a focal point for examining the full scope of IRS management and budget issues. In addition, it would coordinate the sharing of information on IRS operations among the Committees of jurisdiction. Finally, a joint entity could play a constructive role as a forum for enhanced communication among the various Committees of jurisdiction and between the Congress, the IRS and Treasury.

II. TAX SIMPLIFICATION

The Commission focused on tax simplification as a major step in improving the administration of the tax law. We strongly agree, and emphatically endorse its conclusions on the relationship between the complexity of the tax law and its administration. Unless there are meaningful legislative and administrative efforts to simplify the tax law, any changes in IRS governance are doomed to lose their effectiveness.

More specifically, tax law complexity and frequent changes in the Code mean more tax forms and instructions, more computer programming, more regulations and rulings, more training of IRS personnel, more taxpayers requiring assistance, and more disputes with taxpayers. They also mean greater compliance burdens for taxpayers and an increased likelihood of taxpayer filing errors. Increased taxpayer errors, in turn, require the tax administrator to deal with correcting those errors.

Moreover, many of the amendments to the Code enacted in and since 1986 have particularly complicated tax administration and compliance. A significant rationale for this continuing complexity has been stated to be revenue considerations. This need for revenue has resulted in the enactment of provisions that scale back the availability of tax benefits for taxpayers with incomes above certain levels. At the same time, revenue available for tax cuts has been limited, thus constraining the enactment of tax benefits with general applicability. Consequently, the tax benefits enacted have been carefully targeted to minimize the revenue impact. While the targeting of tax benefits may, in many cases, assist in carrying out laudable goals, the result is significantly increased complexity. The Taxpayer Relief Act of 1997 is replete with examples.

The Tax Section has long been a supporter of simplification. However, because change--even simplification--can be complicating, we recommend that proposals which purport to result in simplification only be adopted if they represent significant simplification, after they have received careful consideration, and then only if the changes are expected to remain in place for the long term.

The House Bill, based on the Commission's recommendation, proposed that a Tax Complexity Analysis be required as a formal part of the legislative process. The Section endorses the Commission's objective of providing relevant information with respect to the complexity of tax legislative proposals to those responsible for their enactment. Indeed, we suggested a similar process in our testimony before the Commission.

We are concerned, however, that the provision included in the House Bill would have little effect on the legislative process. The House Bill requires that such an analysis be provided as part of a Committee's report on a bill, after the Committee markup has already occurred. Thus, as presently envisioned, the Tax Complexity Analysis would not be available at the very time when it would be most useful: the markup.

We believe that a Tax Complexity Analysis will have a meaningful effect on reducing complexity. In order for this to occur, however, the Analysis must be available before members of tax-writing Committees consider proposals, rather than afterward. Therefore, we strongly encourage this Committee to require a Tax Complexity Analysis before a Committee markup in order that it be available to members.

III. IRS BUDGETS

A great many of the 21,000 members of the Section of Taxation typically work with the tax law as their full-time profession, most of them representing taxpayers. Accordingly, we have a particularly large stake in the proper functioning of the Service, as well as experience that bears on many (but not all) of the pending budget issues. In the area of technology, for example, we recognize the importance to the Service of having a far better overall information system, the necessity of the Century Date Change, and the necessity of providing Service personnel with better equipment; nevertheless, we do not have the expertise to suggest how these things should actually be done. Similarly, we cannot evaluate the dollar estimates in the budget or the specific effects of particular expenditures on compliance with the law.

Our experience and concerns for the tax system are relevant on other points. In particular, we are concerned by the unprecedented intensity of the hostility that has been directed at the Service by some members of the public and Congress. To the extent that extended scrutiny of the Service leads to constructive changes in its operations, then the scrutiny has been justified and can be seen as appropriate. If what develops, however, is a permanent war between the taxpayers and/or Congress, on the one hand, and the Service, on the other hand, everyone—including Congress and the taxpayers--will lose. In a country as large and complex as ours, no tax system can expected to operate successfully without some kind of government organization to collect taxes. If, however, the tax collection organization and its employees are constantly attacked and ridiculed, the tax system will lose the confidence of the American people, and it will be ever more difficult to attract and retain qualified employees.

For these reasons, we have supported the appointment of a Commissioner who could restore the confidence of both Congress and the public in the Service. It is critically important that the Commissioner be supported through the budget in the great effort he must make to improve the Service and its public respect. Accordingly, without meaning to pass on specific technical issues, we hope and urge that the budget finally adopted by Congress will give the Commissioner's program a real opportunity to succeed and restore the Service to an appropriate level of performance and respect.

Another very important issue exists that we would like to emphasize, because it has not received much public attention. It has been well demonstrated that there are taxpayers who have sincerely attempted to comply with the law, but have nonetheless been improperly treated. This problem must be promptly addressed. We are confident that it could also be demonstrated, however, that there are other taxpayers who have evidenced little or no intention of complying with the law. We cannot ourselves compute, and perhaps no one can compute, the full amount of tax due under current law that is neither reported nor collected. Clearly, however, billions of dollars of taxes do have to be collected very year from honest taxpayers because of amounts that were due from, but not paid by, less than honest taxpayers.

Public reluctance to accept higher tax rates has increased pressure on the Service to collect more revenues through more intense compliance. In view of the stress of tax compliance, we recommend against further reducing the already low percentage of returns that are actually audited by IRS personnel. We, therefore, oppose directing fewer resources to the sometimes unpleasant functions of auditing tax returns and of collecting taxes that have already been determined to be due. The statement from the Budget in Brief--"With the shift to improving Customer Service, the impact of the workforce will be significant"--should not reflect any diminished commitment to collecting the taxes due under laws already passed by Congress. In our view, it would be totally inappropriate for the Service to become less effective in collecting taxes justly due. We would not want a tax system in which compliant taxpayer attitude, if it should occur, might take years to reverse.

Finally, the whole premise for enforcing the tax laws by auditing only a small number of returns depends upon effective selection of the returns chosen for audit. For a number of years that selection was based on having a certain number of returns audited in depth, as opposed to auditing only a few items. However, because the Congress has denied the Service the funds to carry out these so-called TCMP audits, the data bank on which the Service bases these critical decisions is becoming increasingly obsolete. It may be that the prior intensive audit program imposed an unacceptable level of burden on the taxpayers affected, but the program generated information essential to the operation of a serious compliance effort. Consideration should be given to authorizing a compromise form of audit that would impose less burden, but still given the Service the information needed.

IV. IRS REORGANIZATION

We believe that Commissioner Rossotti's plans to integrate the functions of the IRS hold considerable potential for improving the operations of the Service, from the viewpoint of taxpayers, Congress and the personnel of the IRS itself. The current breakdown of the Service along supposedly functional lines makes it more difficult for taxpayers to resolve issues with the IRS because it requires them to work with multiple functions in order to resolve a single issue. We believe that it has likewise impeded operations for IRS personnel, because it compartmentalizes tasks and leaves the IRS personnel without a complete picture of the tax system or the taxpayers with whom they are dealing, necessarily making such personnel, and therefore the IRS, less effective.

While, as noted, we believe that Commissioner Rossotti's reorganization plans hold considerable potential, codifying such plans at this time would be a mistake. Times change, and so do the best practices of any customer-driven organization. If the reorganization is codified, the IRS may be unable to change and implement the practices which are the best at the time without Congressional action. We think this would be a serious mistake. While codifying changes may seem like a good idea to those concerned that too often the Service does not follow its own manual, it is very important to resist the impulse to micromanage the IRS.

V. CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.
The Chief Counsel would report to the Undersecretary on matters involving tax and compliance policy and legal interpretation of the tax laws. The Chief Counsel would continue to report to the General Counsel on litInspector Generalation and personnel matters.

By this proposal, we do not advocate that the position of Assistant Secretary for Tax Policy be diminished in any way. The new Undersecretary position would, instead, focus on IRS management and coordination between that management function and tax policy.

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Mr. HORN. I think we will get to a lot of points up in the question series. I want Mr. Mares to get a chance here.

Mr. Mares is the chair, Tax Executive Committee of the American Institute of Certified Public Accountants. Welcome.

Mr. MARES. Thank you, Mr. Chairman, members of the committee. Thank you for inviting the American Institute of Certified Public Accountants to testify before you today. My comments will be limited to recommendations to improve the overall management of the IRS to serve taxpayers better. Of course, on request, we will be happy to provide you with a copy of our prior written testimony and/or comments that deal with other related issues.

For your information, attached as appendix A is a list of prior testimony and the most pertinent written comments. Because of the time constraints, I will merely summarize our key recommendations.

In our opinion, the most significant management problems confronting the IRS are the need for management continuity and access to varied expertise, a change in the overall internal culture of the IRS, a customer service approach to operations, updating the agency's technology, and stability and continuity in taxation.

Just as there is a need for stability and continuity in the overall governance of the IRS, we believe there is also a need for stability and continuity in its executive leadership. Accordingly, we recommend that some positions now reserved for career civil service employees be open to professional appointees, who would be chosen based on their professional competence and experience. These appointees could provide the IRS with a fresh perspective and understanding of taxpayer and practitioner concerns. They would also help reduce distrust and facilitate a better working relationship with the public and with tax practitioners.

There are two specific positions that we believe would best be filled by individuals with professional experience outside the IRS. Those are the taxpayer advocate and the director of practice.

The IRS has been a closed organization for many years, with many of its employees having little or no professional experience outside of the Service. This can lead to misunderstandings, suspicion and a "them against us" attitude toward taxpayers.

Because of factors such as inadequate training, uncompetitive salaries and IRS bashing, many well-qualified people do not consider IRS employment or, if hired, leave the Service. As hearings last fall and recent internal IRS audits have disclosed, many of those who do work for the Service have been given mixed messages regarding the professional standards that apply to their jobs. As a result, there is a need to revitalize and reform the IRS at all levels.

The IRS culture should foster and promote a highly competent professional approach to tax administration with a primary goal of providing superior customer service. How do you achieve this? First, implement and maintain high educational standards that must be satisfied both to be hired and to be retained. Then, provide coordinated superior training programs. Emphasize professionalism by codifying and enforcing professional standards and by devising performance measures to reward those who further the mission of the IRS. And, finally, pay competitive salaries.

Over the past year, there has been much demand for the IRS to provide better service to taxpayers. In response, several initiatives, such as the problem solving days the Commissioner mentioned and increased phone service, have been instituted. The Commissioner is also developing a proposal that would reorganize the IRS along customer lines to enable it to provide better service, more specifically designed for those particular customers or taxpayers.

We support these proposals and offer our ongoing assistance for these as well as other customer service initiatives. But beyond these customer service initiatives, however, we also believe there is a need for the enactment of additional taxpayer rights provisions. I would refer you to our written testimony at the January 29, 1998 Senate Finance Committee hearing for a discussion of the measures we believe should still be enacted.

Converting the IRS into a customer-driven organization will require not only strong leadership and a change in the internal culture of the Service, but also improved technology. We strongly urge you and other Members of Congress to provide the IRS with the support necessary not only to modernize their technology, but to help keep it current in future years.

As my colleague, Mr. Tucker, pointed out, the IRS can be restructured over and over again, but the basic frustration that taxpayers and tax practitioners experience with the IRS will remain until the issue of the complexity of the tax law has been adequately addressed. It is obvious to those of us here today that tax law complexity originates not from the Service, but from Congress. That point, however, is lost over and over again on the average American.

Regardless, though, of who created this complexity, the fact remains that the tax law is entirely too complex. Congress, Treasury, the Internal Revenue Service, tax practitioner groups, and the American public should all assume responsibility for simplifying and stabilizing the Internal Revenue Code. We urge Congress to apply a complexity analysis prior to passing any legislation affecting our tax laws.

I have undertaken the liberty of attaching the AICPA tax complexity index as a sample of available analysis that could be undertaken. We also urge the IRS to provide Treasury and Congress with information regarding the administrative and taxpayer burdens that result from tax proposals as they are discussed, not merely once a year as part of the taxpayer advocates' annual report to Congress.

As some of these actions have been undertaken, I would submit to you that the members of the AICPA, the bar, and the enrolled agents, including myself, would have had a much easier time this year explaining some of the capital gains provisions to clients.

I also think the millions of notices that will probably be sent out to taxpayers who incorrectly filed their return by not realizing there were new laws and what those new laws required could have been avoided.

I will be happy to answer any questions you have regarding these matters. Thank you for your attention.

[The prepared statement of Mr. Mares follows:]

INTRODUCTION

Mr. Chairman and members of the Committee: Thank you for inviting the American Institute of Certified Public Accountants ("AICPA") to testify before you today. I am Michael Mares, Chair of the AICPA Tax Division. The AICPA is the national, professional organization of more than 331,000 certified public accountants. The Institute's members advise clients on Federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's largest businesses. It is from this base of experience that the AICPA offers its comments.

Over the past year, the AICPA has actively participated in much of the discussion regarding improving the operations of the IRS. We testified at numerous hearings, attended various meetings, and provided written and oral comments and suggestions to the National Commission on Restructuring the Internal Revenue Service, the House Ways and Means Committee and its Oversight Subcommittee, and the Senate Finance Committee.

Our comments today will be limited to recommendations to improve the overall management of the IRS to better serve taxpayers. On request, we will be happy to provide you with a copy of our prior written testimony and/or written comments that deal with other issues. For your information, attached as Appendix A is list describing that prior testimony and the most pertinent written comments.

MAJOR PROBLEMS AND RECOMMENDED SOLUTIONS

In our opinion, the most significant management problems confronting the IRS are the need for: (1) continuity and access to varied expertise in the management of the IRS; (2) a change in the overall internal culture of the IRS; (3) a customer service approach to operations; (4) updating the agency's technology; and (5) stability and simplification of the tax law.

<u>Continuity and Access to Varied Expertise for IRS Management</u>

Independent Oversight Board

The IRS is a large, complex organization; the structure and governance processes which have served it well in the past will not do so in the future. The AICPA believes a fundamental change in the governance of the IRS is needed to provide the IRS with consistent direction and to enable the IRS to benefit from private sector experience and expertise. Thus, we support the proposals to create an independent Internal Revenue Service Oversight Board ("Board"). We take exception, however, with some of the criteria for selection of members, as discussed later.

<u>Need for Changing the Way the IRS is Governed</u>. There is public consensus, agreement within Congress and the Administration, among tax professionals and, importantly, within IRS

management, that the agency requires revitalization and renewal. The expertise needed to govern the IRS can no longer be easily categorized into the two broad components, tax policy and tax administration. Instead, IRS Commissioners now wrestle with massive information systems projects, the need to dramatically improve financial management, re-engineering IRS work processes and providing dramatically improved customer service. At the same time, the traditional expectations of increasing voluntary compliance, handling non-compliance and collecting tax revenues must still be met. Thus, the need for additional and different perspectives on managing these broad challenges is very clear. This is not an indictment of the present structure. It is, however, a recognition that the unprecedented challenges facing the IRS require a different approach and new mix of governance skills and abilities.

Board's Powers and Responsibilities. The Oversight Board's Powers and Responsibilities should have powers and responsibilities similar to those of a corporate board of directors; it should not be merely another advisory group. The Board should provide direction, oversight, and support for the IRS management and make policy decisions regarding IRS operations. Tax policy decisions should remain the responsibility of Treasury.

The IRS Oversight Board's responsibilities should include providing input on long range strategic planning, approving the IRS strategic plan, monitoring organizational performance, and evaluating compensation for the Commissioner and the top-level IRS managers. Similar to a corporate board of directors, the Oversight Board's activities should remain at the programmatic management level and address systemic problems, but not, for example, specific instances of employee misconduct, although the Board should be advised of generic employee misconduct problems in order to evaluate the systemic response and devise corrections.

Further, since the Oversight Board should focus on the overall governance of the IRS and not deal with day-to-day activities, it should not be involved in specific law enforcement cases. In its policy-making and oversight roles, however, the Board should have authority over policies regarding how the IRS carries out its law enforcement responsibilities.

Appointment Based on Expertise. The current House and Senate Finance Committee proposals specify that the private sector members of the Board are to be selected on the basis of their professional experience and expertise so that collectively, the members can contribute to the Board expertise in management of large service organizations, customer service, federal tax laws (including tax administration and compliance), information technology, organization development, and the needs and concerns of taxpayers. The AICPA strongly supports the concept of stated areas of required expertise for the current Board, especially the need for individuals with practical experience and expertise in tax compliance and the needs and concerns of taxpayers. The AICPA also strongly believes that all Board positions, other than positions reserved for the Commissioner and for the Secretary or Deputy Secretary of the Treasury, should be filled based solely on the qualifications of the individuals and the needed expertise of the Board. The AICPA, therefore, believes no position on the Board should be reserved for representatives of special interest groups such as the IRS employees union.

Improved Tax Policy Deliberations Because of Independent IRS Voice. While concerns have been expressed that separating the IRS from Treasury will undermine tax policy effectiveness, we believe it will actually have the opposite effect. Independence will provide the IRS with the ability to provide needed input into the impact of tax policy and legislative proposals on compliance. We understand that this input will be limited to taxpayer burdens and administrative complexity inherent in such changes. This is important information, however, which should be, but currently is not always, made available to Congress or the public. The current relationship between the IRS and Treasury does not give the IRS an independent voice on such issues.

For example, IRS tax administrators were extremely concerned about the difficulty and complexity involved in administering the earned income tax credit when the concept was first introduced. Those concerns were not expressed to Congress because the IRS was limited in its ability to discuss the impact of tax policy on administration, except with Treasury's guidance. It was several years before Congress and Treasury took notice of IRS's concerns. Creating more independence for the IRS would allow the IRS to more clearly articulate its views when such debate is underway, thus reducing the practical problems in implementing specific provisions.

Increased Continuity of Oversight as well as Accountability. Under the current House and Senate Finance Committee proposals, the Board members (other than the initial Board members) would serve five-year staggered terms. This structure would provide much-needed stability in the overall governance of the IRS and contrasts markedly with the very limited governance continuity under the current system. Further, since Board members would be appointed by the President, confirmed by the Senate and could be removed at will by the President, there would be controls in place to ensure integrity and accountability.

Avoidance of Conflict of Interest. Much has been written and said about the potential for conflicts of interest if there is a primarily private sector Board for the IRS. If the Board is to focus on the overall governance of the IRS, not to deal with day-to-day decisions or specific law enforcement matters in the IRS, conflicts should not arise. It is our understanding the Board members will be subject to conflict of interest rules in the *United States Code*. It thus appears that there are adequate statutory safeguards. If not, we believe that additional safeguards could be drafted to prevent conflict of interest problems.

It also should be noted that the conflict of interest discussions seem to be concerned with potential members of the Board who would serve as executives of business enterprises at the same time they serve on the Board. Even if it were determined that potential conflict of interest problems could not be adequately addressed with respect to such individuals, we believe there is a large pool of highly qualified individuals who could serve on the Board, for example, retired business executives, retired professionals, or educators, all of whom could meet the criteria for serving on the Board, without raising the specter of a potential conflict.

No Sunsetting of the Board. The Oversight Board should not be subject to a sunset. The Board would be established to provide the IRS with much-needed stability through consistent direction and to enable it to benefit from private sector experience and expertise. These are ongoing, systemic needs of the IRS. The Board should remain in place to meet those needs, not subject to termination because the perceived problems that caused the Board's creation are resolved.

Restoration of Public Confidence in the Internal Revenue Service. The professional men and women who manage and work for the Internal Revenue Service have been the subject of unprecedented criticism over the past three years. Some of the criticism is valid, but much is not. Obviously, there have been operational problems such as the documented difficulties with the Tax System Modernization program and the taxpayer abuse cases disclosed in hearings last fall. While problems such as these need to be addressed, the AICPA believes it is time to focus on the future direction of the IRS as well. The proposed Board would serve as the catalyst to do so.

Commissioner

Need for Stability and Continuity. Just as there is a need for stability and continuity in the overall governance of the IRS, there is a need for stability and continuity in its senior management. The current system, with no fixed term of office for the Commissioner and the possible appointment of a new Commissioner with each new Administration, does not provide the stability required for such a vitally important leadership position. The AICPA, therefore, supports the House and Senate Finance Committee proposals for a fixed five-year term for the Commissioner.

Powers and Responsibilities. The Commissioner and the senior management of the IRS should have powers and responsibilities similar to the president and senior management of a corporation. They should have responsibility for directing the day-to-day activities of the IRS in a manner consistent with the management policies established by the Oversight Board and be answerable to the Board for those activities.

Executive Leadership

Need to Expand Leadership and Retain Qualified Career Executives. The IRS has been a very closed organization, with its executive leadership consisting almost exclusively of IRS career employees. People with varied backgrounds and expertise need to be added to that leadership to provide the IRS with different insights and to help generate innovative approaches to the many challenges confronting the IRS. Also, steps need to be taken, such as providing flexibility in compensation, to encourage qualified IRS career executives to remain with the IRS so that their knowledge and expertise is not lost.

Professional Appointees. To facilitate broad approaches and thinking on issues, AICPA recommends that some positions now reserved for career civil service employees be open for "professional appointees." These professional appointees should be selected based on their professional and managerial competence rather than political affiliation and should be appointed by the Commissioner with the approval of the Board.

Emphasis should be placed on using professional appointees in positions managing program execution rather than solely in policy-making positions. To prevent such appointees from dealing directly with specific taxpayer cases, no such appointments outside the National Office should be for positions below the Regional Commissioner level.

Taxpayer Advocate's Office

Responsibility to Represent Taxpayers. The Taxpayer Advocate's Office is in the unique position of being inside the IRS, yet having the specific charge of representing the interests of American taxpayers, scrutinizing the Service's activities, and serving as the advocate of taxpayers in recommending changes that will improve the IRS's service and responsiveness to taxpayers. Given that role, the Taxpayer Advocate must zealously represent taxpayers, not serve as a spokesperson or apologist for the IRS.

Need for Independence. For the Taxpayer Advocate's Office to fulfill its responsibilities, it must have the trust of taxpayers. We recognize that, from a realistic point of view, it is probably necessary to have the Taxpayer Advocate's Office be part of the IRS, so that the employees of the Advocate's Office can have access to taxpayer information. The fact that the Office is organizationally a part of the Internal Revenue Service, however, may taint its objectivity in the minds of taxpayers. It is, therefore, crucial that the Taxpayer Advocate's Office be structured and operated in such a manner as to maximize the independence of its advocacy. For example, the Taxpayer Advocate should be appointed by and report directly to the independent Oversight Board instead of to the Commissioner.

While we recognize the many contributions already made by the Advocate's Office, based on the Taxpayer Advocate's annual reports to Congress in 1997 and 1998, it appears the Taxpayer Advocate's view of issues is too heavily weighted from the IRS' perspective rather than that of the taxpayers. The weighted IRS perspective, unfortunately, sends the message to the taxpaying public that the Advocate may not be independent. This image must be changed.

Director of Practice

Currently, the Director of Practice is appointed by the Secretary of the Treasury. The Director of Practice acts upon applications for enrollment to practice before the IRS, institutes and provides for the conduct of disciplinary proceedings relating to attorneys, certified public accountants, enrolled agents, enrolled actuaries and appraisers, makes inquiries with respect to matters under the office's jurisdiction, and performs such other duties as are necessary or appropriate to carry out the functions of the office as described above or as prescribed by the Secretary of the Treasury.

Qualifications for Selection. We recommend that the Secretary of the Treasury be required to obtain input regarding the selection of the Director of Practice from the Board and that a candidate for the position should have either substantial experience as a tax practitioner representing taxpayers before the IRS or substantial experience within the IRS working with tax practitioners. The primary source of candidates should be from outside the IRS.

Expansion of Responsibilities. We also recommend that the Director of Practice's responsibilities be expanded to include monitoring the leading causes of disciplinary action against tax practitioners and developing recommendations for reducing the occurrence of such causes, developing criteria for the process and types of cases where referral of tax practitioners is appropriate, and maintaining close relationships with tax administration and professional organizations. The Director of Practice should also work closely with the IRS chief compliance office in establishing standards for ethical behavior on the part of IRS employees.

Accounting and Financial Records Advisory Group

The IRS board of directors should establish an advisory group of CPAs/CFOs (in effect, an audit committee) from the private sector. The group should act as an advisor to the IRS on the financial statement and accounting issues raised by the GAO in its financial statement audits, as well as serve as a resource to the GAO on the issues and corrective actions involved in the annual financial statement preparation and audit processes.

Change in IRS Culture

Recruitment and Retention of the Best for the IRS

Employment at the IRS has always been viewed as a professional career. In the past, the IRS successfully recruited entry level personnel who not only grew with the organization, but who today are leaders in the tax field both inside and outside the IRS. Ensuring the continuity of this succession of leaders will require improvements in recruitment, training, and compensation, as well as clarification of career paths for IRS employees. The IRS's strategic plan needs to focus on accomplishing these objectives.

Competitive Salaries. In many geographic locations, IRS salary levels are woefully uncompetitive. The IRS must be capable of paying competitive salaries in order to recruit and retain qualified employees. If this raises issues of equity among governmental agencies, we would note that no other agency so touches the lives of the U.S. public, and no other agency is charged with raising over $1.5 trillion a year.

Superior Training. Superior training has been one of the attractions of a career with the IRS. Obviously, better trained IRS employees work more efficiently and taxpayers have a better experience dealing with properly trained IRS employees. Conversely, for taxpayers and tax professionals, dealing with ill-informed auditors often results in wasted time resolving needless issues and promotes negative attitudes toward the IRS.

High Educational Standards. High educational standards must be set for IRS employees. These standards should require both a quality accounting education as a prerequisite to hiring and dismissal of agents who cannot pass training.

Increase in the Number of CPAs in the IRS. To increase the depth of knowledge and practical experience of IRS employees, it is recommended that the practice of hiring CPAs in the Office of IRS Chief Counsel be reinstated and that continuous and active recruiting of CPAs in the Examination Branch be undertaken. Further, in connection with continuing education for IRS employees, non-CPA employees should be encouraged to become CPAs.

Professionalism and Image

The "Forward" to the *IRS Rules of Conduct* notes that public confidence in the Service "can be instilled and maintained only if every contact with the public reflects high ethical standards and [the] commitment to perform [the] work conscientiously, courteously, and effectively." The professionalism that is present in the executive ranks of the IRS must be passed down to employees at all levels.

Codification of Professional Standards. The IRS should codify and enforce its professional standards. Due to the interdisciplinary nature of tax standards, the IRS and professional tax organizations should form a working group to collegially develop such standards of professionalism.

Job Performance Measurements. In testimony before the National Commission on Restructuring the Internal Revenue Service and in a July 7, 1997 letter to the IRS, the AICPA objected to the measurement standards applied to job performance of IRS employees and encouraged measurement based on professionalism. Better performance measures must be devised to reward performance that furthers the mission of the IRS rather than encourage overly aggressive and unjustified proposed adjustments and collection actions. We are pleased with the actions taken thus far in this area and hope the process of improving the measurement system is continued.

Public Relations Campaign. As a means of increasing employee morale as well as aiding compliance and reducing negative ratings, the IRS should communicate to the public that it works in the public interest carrying out the mandates of Congress.

Customer Service Approach

Customer Service Initiatives

Over the past year, much has been written and said about the need for the IRS to provide better customer service to taxpayers and several initiatives, such as problem solving days and increased phone service, have been instituted. The Commissioner has developed a proposal that would reorganize the IRS along customer lines to enable it to provide service more specifically designed for the particular customer/taxpayer. In addition, the Customer Service Task Force, as part of the National Performance Review, recently issued a report that lists numerous customer service initiatives. We are heartened by such proposals.

We have indicated to the Commissioner that our initial reaction to the concept of reorganizing the IRS into business units focused on taxpayers with similar characteristics is extremely favorable. The concept should provide the Service with the ability to focus on the specific needs of each business group, assist with taxpayer compliance, and tailor enforcement procedures to the specific issues of each group. The overriding principle of the concept that we endorse is that of focusing the Internal Revenue Service's efforts outside of the organization, to taxpayer and practitioner needs, rather than toward the internal operation. We believe that the concept, if developed as described to date, will improve the ability of taxpayers to comply with the country's complicated tax laws, and better enable the Service to direct its limited resources toward enforcement of those laws.

We also noted to the Commissioner that transitioning the Internal Revenue Service from its current organizational structure, culture and functions to that envisioned by his proposal will be extraordinarily challenging and offered our assistance. Likewise, we offer our assistance in helping with other customer service initiatives.

Taxpayer Rights Proposals

Beyond these customer service initiatives, there also is a need for the enactment of additional taxpayer rights provisions. A detailed discussion of those provisions is set forth in our written testimony for the January 29, 1998 Senate Finance Committee hearing; we will be happy to provide you with a copy of that testimony on request.

Updating IRS Technology

To convert the IRS into a customer service-driven organization will require not only strong leadership and a change in the IRS internal culture, but also improved technology. We urge you and other members of Congress to provide the IRS with the support necessary to bring the technology of the IRS up-to-date and to keep it current in the future.

Stability and Simplification of the Tax Law

The IRS can be restructured over and over again but the basic frustration taxpayers experience with the IRS will remain until the issue of the complexity of the tax law has been addressed. It is obvious to those of us here today that tax law complexity originates not from the IRS, but from Congress, through the complex tax laws it enacts and the constant changes it makes to those laws. That may not be so obvious to the average citizen, however.

Regardless of who has created the complexity, the fact remains that the tax law is entirely too complex and, as evidenced by the capital gains provisions in the *Taxpayer Relief Act of 1997*, continues to become more so. Congress, Treasury, the IRS, and tax practitioner groups all should assume responsibility for doing whatever we can to bring simplification and stability to the tax law. The IRS should be particularly interested in pursuing simplification and stability in the tax laws and take an active role.

We urge Congress to apply a complexity analysis prior to passing any legislation affecting the tax laws. We also urge the IRS to provide Treasury and Congress with information regarding the administrative and taxpayer burdens that would result under legislative proposals that would affect the tax laws; this information should be provided throughout the year as the proposals are being discussed, not merely once a year as part of the Taxpayer Advocate's annual report to Congress.

We refer you to our written testimony for the November 8, 1996 hearing of the National Commission on Restructuring the Internal Revenue Service for a more detailed discussion of the tax law complexity issue and the AICPA Tax Complexity Index.

CLOSING COMMENTS

The AICPA appreciates the opportunity to offer comments at today's hearing and is willing to provide your committee with additional assistance and comments as requested. Thank you for your attention.

APPENDIX A

Prior AICPA Testimony and Written Comments Regarding IRS Restructuring and Reform Issues

1. Testimony on tax law complexity, with proposals for introducing simpification considerations into the legislative process (11-8-96 hearing of the National Commission on Restructuring the IRS).

2. Testimony presenting taxpayer rights proposals (2-26-97 hearing of the National Commission on Restructuring the IRS).

3. Testimony on IRS budget and the impact of inadequate funding (3-18-97 hearing of the House Ways and Means Subcommittee on Oversight).

4. Testimony on overall recommendations to improve the IRS (4-17-97 hearing of the National Commission on Restructuring the IRS).

5. Testimony on goverance and oversight of the IRS (9-17-97 hearing of the House Ways and Means Committee).

6. Testimony commenting on the taxpayer rights provisions in H.R. 2292, the *Internal Revenue Service Restructuring and Reform Bill*, and proposing additional taxpayer rights provisions (9-26-97 hearing of the House Ways and Means Subcommittee on Oversight).

7. Testimony commenting on some of the most significant provisions and topics in H.R. 2676, the *Internal Revenue Service Restructuring and Reform Bill*, as passed by the House, and H.R. 2292, its predecessor (1-29-98 hearing of the Senate Finance Committee).

8. Letter, dated 3-6-98, to Commissioner Rossotti, commenting on his proposed new concept of operations for the IRS.

9. Letter, dated 3-17-98, to staff of the Senate Finance Committee, regarding penalty and interest reform.

10. Letter, dated 3-20-98, to Senators Roth and Moynihan regarding interest netting proposals.

11. Letter, dated 3-25-98, to Senator Roth regarding various IRS restructuring issues.

Final -- February 28, 1997

AICPA TAX COMPLEXITY INDEX

The attached *AICPA Tax Complexity Index* was first developed in 1992 by the AICPA Tax Simplification Committee, revised by the Tax Policy and SimplificationCommittee, and approved by the Tax Executive Committee in 1997. The *Index* is a tool for measuring complexity factors as detailed in the *AICPA Blueprint for Tax Simplification* issued in 1992. The purpose of the *Index* is to assess the relative complexity (or simplification) of proposed tax law changes. The *Index* is used by AICPA committees when developing legislative proposals and comments. The AICPA also encourages Congressional tax writing staffs to use the same or a similar index when considering and drafting proposed legislation.

The *Index* consists of two parts. The first section includes 15 relatively objective, multiple choice questions. The scores for the first 15 questions should be totaled and the resulting numerator divided by a denominator of 15 to arrive at an average score for the provision being considered. If a question is not applicable to the provision being considered, it should be eliminated from the scoring and the denominator should be reduced by one for each question eliminated. The resulting "overall complexity index score" may be interpreted as follows:

-1.5 or below	substantial simplification is achieved
-.8 to -1.4	moderate simplification is achieved
-.1 to -.7	minor simplification is achieved
0	no increase in complexity, no contribution to simplification
+.1 to +.7	minor increase in complexity
+.8 to +1.4	moderate increase in complexity
+1.5 or above	substantial increase in complexity

If a particular legislative proposal scores in the positive range, it does not mean that it should always be discarded as too complex. The evaluator should then consider the second section which includes six subjective questions that address issues that must be examined in conjunction with the overall complexity index score.

Questions in the *Index* are designed to assess many of the complexity factors discussed in detail in the *Blueprint*. The problem of an overly complex tax system has arisen in part because of the dominance of other legislative goals, such as revenue enhancement, rate reduction, and economic and social policy. Even working within the constraints imposed by the need to balance the various objectives of the tax system, it is possible to achieve a simpler tax system. Because complexity is a multidimensional concept, no single index can measure complexity in an absolute sense. For example, the relative importance or weight of a particular complexity factor depends in part on the type of taxpayer or transaction involved. Users of the *Index* are therefore cautioned to consider the context of a particular provision when answering the questions. The resulting score should then be viewed as a measure of comfort or discomfort with a proposed tax law change.

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AICPA TAX COMPLEXITY INDEX

1. What is the nature of the proposed provision?

a.	Entirely new provision introduced.	+3
b.	Prior provision modified, replaced or reinstated with one or more changes to this provision in recent years.	+2
c.	Prior provision modified, replaced or reinstated with no other changes to this provision in recent years.	+1
d.	Existing provision repealed or expired and not replaced.	-1
e.	Provision that requires particularly complex legislative or regulatory calculations is repealed or replaced.	-3

2. When will this change be fully effective? (Eliminate this question if not applicable.)

a.	Retroactively or at mid-year with some taxpayers having to file amended returns.	+3
b.	Gradually, with changes being phased-in over two or more years.	+2
c.	Fully effective at end of current year.	+1
d.	Not until next year.	0
e.	Not until some specific date more than one year in the future.	-2

3. Will prior rules continue to apply to assets acquired or transactions entered into prior to this change? If yes, for how long?

a.	Yes, for five or more years.	+2
b.	Yes, for less than five years.	+1
c.	No	0

4. Will tax forms (and instructions) need to be designed or revised as a result of this change?

a.	A new form will be needed.	+3
b.	Major additions needed to existing form.	+2
c.	Minor additions needed to existing form.	+1
d.	No form changes needed.	0
e.	An existing form can be slightly shortened.	-1
f.	An existing form can be substantially shortened.	-2
g.	An existing form can be eliminated.	-3

5. Does effective date give sufficient time to implement changes on forms, instructions, and taxpayer information materials? (Eliminate this question if not applicable.)

a.	No, and tax forms and instructions applying prior rules may have already been finalized.	+3
b.	Yes, but a major reallocation of resources will be needed.	+2
c.	Yes, but some further work may be needed in future periods.	+1
d.	Yes, because only minimal or no changes needed.	0
e.	Only future forms will change.	-1

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6. Are changes clear and unambiguous or will further clarification be needed? (Annual CPI adjustments should not be considered.)

a.	Major clarification needed and/or regulations have been mandated by legislation.	+3
b.	Moderate clarification is needed.	+2
c.	Minor clarification is needed.	+1
d.	No clarification anticipated.	0
e.	Minor ambiguity in prior law clarified.	-1
f.	Moderate ambiguities in prior law clarified.	-2
g.	Major ambiguities in prior law clarified.	-3

7. Will clarification be available prior to applicable filing season? (Eliminate this question if not applicable.)

a.	No	+3
b.	Temporary guidance, such as committee reports, provide some clarification, but further work will be needed.	+2
c.	Yes, but some further guidance may be needed in future periods.	+1
d.	Yes, but major reallocation of resources will be needed.	0
e.	Yes, because sufficient time exists to draft guidance.	-1
f.	Provision is self-explanatory and no guidance needed.	-2

8. Does this change include specialized terminology requiring definition(s)? (Annual CPI adjustments should not be considered.)

a.	Yes, and the definitions are either not included in the legislation or they differ significantly from similar terms defined elsewhere in tax statutes and regulations.	+3
b.	Yes, and this legislation clearly defines new terms not previously defined by tax statute and regulations.	+2
c.	Yes, and the definitions are found elsewhere in tax statute and regulations.	+1
d.	No specialized terminology is included in this change.	0
e.	Yes, and this provision serves to simplify the definition of such terminology used elsewhere in the code.	-1
f.	A previous conflict in terminology is eliminated by this change.	-2

9. Are the concepts and definitions used in this provision consistent with those found elsewhere in the law (i.e., was there horizontal drafting)?

a.	No, and redrafting of other code sections will be needed to provide consistency.	+3
b.	No, but there is adequate justification for allowing inconsistent rules or definitions.	+2
c.	No, but differences are minor and maybe easily remedied.	+1
d.	Yes	0
e.	Some previous inconsistencies are now eliminated.	-1
f.	Many inconsistencies are eliminated.	-2
g.	The need for certain definitions is eliminated.	-3

10. How will this change affect recordkeeping requirements?

a.	Substantial records, not normally kept in ordinary course of business, investment, or personal affairs, will now be required.	+3
b.	Data in records normally kept for other purposes will have to be substantially reorganized for tax purposes.	+2
c.	Minor recordkeeping requirements are added.	+1
d.	There are no changes in recordkeeping requirements.	0
e.	Minor recordkeeping requirements eliminated or reduced.	-1
f.	Moderate recordkeeping requirements eliminated or reduced.	-2
g.	Substantial recordkeeping requirements eliminated or reduced.	-3

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11. How will this change affect the number and type of calculations that must be made on and off the tax form?

a.	Many and complex calculations added.	+3
b.	Many simple calculations added.	+2
c.	Some simple calculations added.	+1
d.	No calculations added.	0
e.	Some simple calculations eliminated.	-1
f.	Many simple calculations eliminated.	-2
g.	Many complex calculations eliminated.	-3

12. Will taxpayers need to make calculations just to determine whether this provision applies to them?

a.	Yes, substantial calculations needed to determine applicability.	+3
b.	Yes, some calculations needed to determine applicability.	+2
c.	Yes, minor calculations needed to determine applicability.	+1
d.	A safe harbor or threshold amount eliminated calculation to determine applicability.	0
e.	No calculations needed to determine applicability.	-1

13. Does this change require taxpayers to make redundant calculations involving essentially the same data? Also, to what extent do tax calculations vary from standard recordkeeping practices or other industry standards?

a.	Multiple, redundant calculations involving essentially the same data are required for tax purposes, and these calculations vary substantially from those done for other purposes.	+3
b.	Only one set of tax calculations needed, but they vary substantially from those done for other purposes.	+2
c.	There are minor differences between tax and required accounting calculations.	+1
d.	No redundant calculations required.	0
e.	Minor redundant calculations eliminated.	-1
f.	Moderate redundant calculations eliminated.	-2
g.	No substantially parallel tax calculations or other accounting calculations are required.	-3

14. Are the calculations, definitions, and recordkeeping requirements understandable for the target population?

a.	No, compliance burdens will be excessive.	+3
b.	Moderate difficulty will be encountered.	+2
c.	Minor difficulty will be encountered.	+1
d.	No problems anticipated.	0
e.	Minor difficulty has been eliminated.	-1
f.	Moderate difficulty has been eliminated.	-2
g.	Major difficulty has been eliminated.	-3

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15. Is the level of tax law complexity appropriate for the complexity of the targeted transactions?

a.	No, compliance burdens will be excessive.	+3
b.	Tax law complexity moderately excessive.	+2
c.	Tax law complexity slightly excessive.	+1
d.	Complexity of provision clearly justified by nature of targeted transactions.	0

In addition to the above questions which can be posed in a relatively objective manner, the following subjective questions need to be evaluated in determining a provisions overall complexity:

16. Besides complete repeal, can the objective of this change be achieved in a simpler manner?

17. Do the benefits of this change outweigh the costs of compliance and administration?

18. Does the simplification achieved lead to substantial unfairness?

19. Has this change been given adequate hearing and debate?

20. Is the proposed statute clearly written and logical?

21. Are a significant number of taxpayers now required to make (or relieved of making) difficult calculations or to meet involved filing requirements?

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Subject: ______________________________

Code Section: ______________________________

Source/Reference: ______________________________

Nature of Recommendation:

Administrative ________ Legislative ________

Policy ________ Technical ________

Details of Complexity Index Rating/Score for Each Question:

Q1 ________	Q6 ________	Q11 ________
Q2 ________	Q7 ________	Q12 ________
Q3 ________	Q8 ________	Q13 ________
Q4 ________	Q9 ________	Q14 ________
Q5 ________	Q10 ________	Q15 ________

__________ Total for Question 1 - 15

______ ÷ 15 ____ Divide by 15 (Reduce this number by one for each question eliminated -- See questions 2, 5, and 7.)

__________ Overall Complexity Index Score

Answers to subjective questions:

Q16.

Q17.

Q18.

Q19.

Q20.

Q21.

Mr. HORN. Well, we thank you. I know you have to grab a plane, and I don't want to rush you, but some of the testimony will come out in the questions and answers, if you can stay with us a little bit. I thought your appendix A was immensely helpful in terms of what you have done as professionals with various congressional committees, so we appreciate that.

We now move to the National Academy of Public Administration and Mr. Thomas H. Stanton is chair of the Standing Panel on Executive Organization and Management of the National Academy of Public Administration; and he is accompanied by an old friend of mine named Herbert Jasper, who has been a witness many times before this subcommittee who is also a member of the Standing Panel on Executive Organization. Now that group, I will say to anyone who cares, that they probably have several thousand years of high executive experience in that group. Some of them have been at it for 50 years apiece, and that ups the number to easily a thousand. But it is a very wise group of people, even if I maybe disagree with a recommendation here and there. So, Mr. Stanton, we are glad to have you with us.

Mr. STANTON. Thank you very much, Mr. Chairman. We are absolutely delighted at your constant probing of government management issues in one area after another, and the IRS, of course, is one of the most important.

In our testimony on IRS, we would like to make four major points. First, we support recommendations of the National Commission and the provisions of H.R. 2676, the IRS Restructuring Act, to strengthen congressional oversight and dedicate greater congressional attention to management issues. The National Commission focused on increasing the involvement of the congressional tax committees, but H.R. 2676 wisely includes the Government Reform and Oversight Committee in the oversight process, and we hope, by extension, this subcommittee. Greater involvement of your subcommittee in oversight can help to promote accountability of the IRS and to assist its managers in addressing some of the problems of an ingrown organizational culture.

This subcommittee also could assist IRS in applying the Government Performance and Results Act to assure that the agency pursues performance goals that strike an appropriate balance between the need to collect revenues efficiently and the need to treat taxpayers responsibly, fairly, and with respect. And indeed, some of the problems pointed out on the Senate side can be seen as deriving from an imbalance and congressional emphasis on tax collection to the detriment of those other values.

Second point. The oversight board that H.R. 2676 proposes for the IRS could gravely damage the accountability of the IRS and the quality of that agency as an institution. These problems can be overcome if the Congress were to turn the oversight board into an advisory board. H.R. 2676 gives the oversight board authority to approve strategic plans, reorganization plans and budgets of the IRS. The bill thus allows private parties to determine the deployment of the Nation's tax collection apparatus and invites self-serving actions by the private board members or invites the perception of such actions that could well lead to increased tax evasion. By giving the oversight board authority on these important IRS decisions, H.R. 2676 will make it difficult for Congress to hold anyone accountable for IRS performance. The Commissioner, individual board members, and the Secretary of the Treasury all will be able to point to others who hold partial responsibility for any actions that engender criticism.

We urge the Congress, as it did in legislation to create an independent Social Security Administration, instead to create an advisory board and retain a single Commissioner as head of the agency who can be held fully accountable to the Congress on behalf of the American taxpayer, as happened this morning. A strong advisory board can help to infuse the IRS with fresh points of view on behalf of the private individuals and companies who must pay taxes and deal with the agency.

Our third point is that management improvements must enhance rather than detract from the professionalism of the IRS. We support the ideas of a fixed term and a performance contract for the Commissioner. H.R. 2676 also makes welcome additions to the flexibility of IRS personnel rules and provides that they should be exercised consistent with merit systems principles. We do urge that the Congress strengthen provisions to assure that merit principles are applied to the hiring of all IRS employees below the level of Commissioner. Otherwise, over time, if not immediately, the agency is likely to be offered a remarkable array of politically well-connected, but marginally qualified people for positions that were intended to be filled by experts.

Our fourth point is reorganizing a large and essential agency, such as the IRS, is a process that is fraught with pitfalls. The Congress should refrain from specifying any details of internal organization in legislation. Commissioner Rossotti has proposed a far-reaching reorganization for IRS. We urge that these profound changes proceed cautiously and with sensitivity for the need to continue vital IRS functions throughout the time when reorganization is occurring. As with government efforts to absorb new technologies on a large scale, the lessons of past Federal reorganizations send a signal of caution. In particular, we believe it would be unwise for the Congress to prescribe any details of a proposed reorganization. Pilot testing of new ideas may reveal that alternative approaches are needed to prevent unintended management consequences. The language of the bill, as it is evolving in the Senate, is likely to be far too rigid to permit the kind of experimentation and adaptation that is needed for a large-scale reorganization to succeed.

Mr. Chairman, we would like to close by pointing out, and here we are echoing Representative Kucinich, that for all of the shortcomings that the Congress has identified, the IRS continues to do a remarkable job. Each year, as the Congressman pointed out, the agency processes over 200 million returns, collects over $1½ trillion of revenues, and provides information and tax advice 100 million times. This committee needs to scrutinize the provisions of H.R. 2676, especially with respect to IRS organization and governance, to assure that new legislation does not endanger that track record. We urge that any IRS restructuring legislation include provision for prompt evaluation of the impact of particular features of the new law upon the ability of this country to continue to collect the revenues that we need. A 5-year sunset provision, especially on any changes to IRS governance structure, will provide the Congress and this subcommittee in particular with an opportunity to refine its approach to these important matters in light of experience.

Thank you very much. We would be pleased to answer questions.

[The prepared statement of Mr. Stanton follows:]

Chairman Horn and Members of the Subcommittee:

Thank you for your invitation to testify on the management and organization of the Internal Revenue Service (IRS). My name is Thomas H. Stanton. I am Vice Chair of the National Academy of Public Administration's Standing Panel on Executive Organization and Management. Another panel member, Herbert N. Jasper, is accompanying me today.

Standing panel members have extensive experience and knowledge about the relationship of organizational structure to the quality of federal management. The panel or its members have often testified on issues such as those presented by the IRS Commissioner's reorganization plans and by H.R. 2676, including those considered in connection with the governance structure for the Social Security Administration and the Resolution Trust Corporation. This statement does not necessarily represent the views of the National Academy as an institution.

The Congress has a vital stake in assuring that IRS carries out the law in an accountable, effective and humane manner. The country will always need an IRS. Whether we have some form of today's tax system, a flat tax or a consumption tax, issues of implementation and good management will always be important to the American taxpayer.

In our testimony today we would like to make four major points:

- We support the recommendations of the National Commission on Restructuring the Internal Revenue Service and the provisions of H.R. 2676 to strengthen congressional oversight of IRS and dedicate greater congressional attention to management issues.

- H.R. 2676 would create an Oversight Board that would greatly limit the accountability of IRS to the Congress, the President and the Treasury Secretary, and damage the professional independence of the agency. These problems can be overcome if the Congress would alter the role of the Oversight Board to be advisory in nature.

- Management improvements must enhance, rather than detract from, the professionalism of IRS.

- Reorganizing a large and essential agency such as IRS is a process that is fraught with pitfalls. The Congress should refrain from specifying internal organization details in legislation.

Let's consider each of these points in turn:

IT IS IMPORTANT TO STRENGTHEN CONGRESSIONAL OVERSIGHT OF IRS

Similar to other large agencies, IRS receives oversight from a large number of committees and subcommittees. Most oversight tends to focus upon particular aspects of tax policy, not on the management implications of those policies. The Joint Committee on Internal Revenue Taxation has played a useful and continuing role in coordinating tax policies, but has not taken a similar role in considering tax system operations and IRS management.

Title IV of H.R. 2676 requires that representatives from three House and three Senate committees, including the House Committee on Government Reform and Oversight, conduct a twice-yearly joint hearing to review the strategic plans and budget of IRS. Further, the Joint Committee is directed to report annually to the six committees upon those matters, as well as on the state of our tax system, taxpayer service and compliance, and technology modernization. We believe those provisions offer an opportunity for constructive oversight of IRS management, as well as for review of tax policies.

This subcommittee could make a substantial contribution to such oversight. For example, the Senate Finance Committee has raised the specter of overbearing IRS collection of taxes. Needed is a congressional mandate for IRS to achieve effective collection of taxes owed while treating taxpayers fairly and decently. The provision of such a balanced mandate could occur through this subcommittee in the context of the Government Performance and Results Act of 1993 (GPRA). A first step would be to ensure that performance goals for the agency relate to the quality of IRS taxpayer service, and not merely to the amount of tax revenue to be collected. In enacting

GPRA, the Congress cautioned agencies about the problem of distorted performance goals. The Senate Governmental Affairs Committee stated in its report on the act that,

> "It is very important that annual performance plans include goals, not just for the quantity of effort, but also for the quality of that effort." [1]

The then-House Committee on Government Operations similarly stated that:

> "The Committee believes agencies should develop a range of related performance indicators, such as quantity, quality, timeliness, cost and outcome. A range is important because most program activities require managers to balance their priorities among several sub-goals."[2]

In the face of pressures to strengthen tax collection efforts, and thereby to reduce the federal budget deficit, this emphasis on balance became lost. In congressional hearings, a General Accounting Office report, and appropriations hearings for the 1995 compliance initiative, IRS was pushed to become more effective at increasing revenues, both from additional audits and through collections from delinquent taxpayers. The need to assure fair treatment of taxpayers was neglected in this emphasis on revenue-raising.

Therefore, we recommend that Congress—and this Committee in particular—take an interest in the balanced implementation of GPRA by IRS, and the development and application of an even-handed set of performance goals. IRS must still be directed to collect the maximum amount of taxes owed, but should also deal reasonably and equitably with those who owe money to the government. GPRA, properly applied with assistance from this subcommittee, can help to set a balanced agenda for IRS.

With a clear set of balanced goals, IRS should then carefully review its internal rules

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"Government Performance and Results Act," report of the Committee on Governmental Affairs, United States Senate, to accompany S. 20, Report 102-429, September 29, 1992, p. 15.

2

"Government Performance and Results Act of 1993," report of the Committee on Government Operations, U.S. House of Representatives, to accompany H.R. 826, Report 103-106, Part I, May 25, 1993, p. 17.

and procedures. It must assure that any guidance to staff, as well as performance standards, and evaluation and reward systems and practices are consistent with the desired combination of effective tax collection and fair treatment of taxpayers. Perhaps a new code of conduct should be developed to embody this balanced approach.

THE PROPOSED OVERSIGHT BOARD WOULD GREATLY REDUCE THE ACCOUNTABILITY OF IRS

The report of the National Commission strongly influenced the content of the bills now being considered by the Congress. Commission members or staff consulted several Fellows of the Academy because of their knowledge of IRS as well as the organization and management of large subcabinet agencies.[3] Since its release in June 1997, the report and the ensuing legislation have been discussed at length by Academy members.

We are pleased that the House substituted an Oversight Board for a board of directors. But, we do not think that the House-passed bill went far enough. H.R. 2676 gives the proposed Oversight Board authority to approve strategic plans, reorganizations, and budgets of the IRS. The bill gives private parties a voice in determining the deployment of the nation's tax collection apparatus and thereby invites self-serving actions by the private board members, or—at a minimum—the perception of such actions. Under this governance structure, the Secretary, the Commissioner, and individual board members, all will share accountability. Therefore, all will be able to point to others who hold partial responsibility for any actions that engender criticism.

Needed instead is a board whose role is advisory in nature to help infuse IRS with fresh points of view on behalf of the private individuals and companies that must pay taxes, while trying to comply with an immense amount of instructions, paperwork, and rules. Such a board could add its voice to those of the Taxpayer Advocate, and perhaps the Chief Inspector, to help inform the process of congressional oversight and raise timely issues of importance to taxpayers and lawmakers. To the extent that a board with an advisory role gives sound advice, and has the ear of the Congress and the Secretary as well, its recommendations will very likely be persuasive to the Commissioner.

Experience shows that, except for independent regulatory agencies with

[3]3 These Fellows include Jonathan Breul, Sheldon Cohen, Alan Dean, Ronald Moe, and Edward Preston.

quasi-legislative and quasi-judicial functions, programs are most effectively managed when a single head is responsible and, of utmost significance, held accountable for performance. There is a real danger that subjecting the IRS Commissioner to additional demands and disagreements generated by the proposed Oversight Board may further compromise his ability to concentrate on essential management tasks such as the effective implementation of the Taxpayer Relief Act of 1997, modernization of the agency's technology, and the resolution of the year 2000 problem.

We believe that the provisions regarding the proposed Oversight Board would seriously jeopardize accomplishment of some of the principal objectives of the legislation. Most important, H.R. 2676 would give powers to the Oversight Board's powers that would make it impossible to hold **anyone** fully accountable for IRS' performance.

We do think the basic concept of having a group of very well qualified persons to review IRS strategic planning, management and operations, and to provide informed advice, is sound and helpful. A board with an advisory role to the Commissioner and the Secretary of the Treasury could open the agency to new ideas. Specifically, it could:

- help assess how the agency is perceived by its customers
- help think outside of the box, by assuring that genuine innovations receive full and fair evaluation and are not rejected out of hand by the bureaucracy
- suggest new management, organizational or administrative ideas or approaches
- provide a sounding board for innovations or changes that the Commissioner is considering

All of these functions could be performed by a board that is advisory in nature. Although the bill uses the term oversight to describe the board that it would establish, under H.R. 2676 the board would, in fact, be a **governing** board. We think it would be a serious mistake to make the Commissioner accountable to a part-time board dominated by eight private citizens.

The kind of board that we are proposing would differ greatly from the current Commissioner's Advisory Group. We are recommending a board that would have substantially more status and authority than the existing advisory group. That group is appointed by the Commissioner and its members serve for single two-year terms. It has no assured access to information, and it reports only to the Commissioner. By contrast, creating a board in statute would give its members more visibility and longer tenure and could guarantee them access to all pertinent documents and data. The provisions in H.R. 2676 could well be expanded and strengthened to assure the board's full access to information beyond the scope of strategic and operational plans, reorganizations and budgets, as now provided in H.R. 2676.

A statutory charter would also provide the new board a formal reporting channel to the Secretary, the Congress and the President. The board could be charged by law with such an important and sensitive function as reviewing complaints of abuse, a responsibility not assigned to the existing advisory group.

The Congress would very likely pay as much attention to the views of a board with a review and advisory role as it would to a board that had decision-making authority. Indeed, the Congress could expect more candid views from such a board than from one that had already approved the decisions that the Congress might be inquiring about, or challenging.

In short, we see many benefits flowing from a strong board with an advisory, rather than governing, role. It could provide the fresh view of outsiders. Those benefits can best be achieved without the dilution of accountability and the additional "layering" that would occur if the board is part of the decision-making process.

Finally, we urge that the provisions respecting the Oversight Board be made subject to a sunset provision. Perhaps a five-year trial period would be appropriate since that is the term proposed for the Commissioner. The ten-year sunset provision, as recently proposed by the Senate Finance Committee, appears to us to be too long a period of time.

MANAGEMENT IMPROVEMENTS MUST ENHANCE, RATHER THAN DETRACT FROM, THE PROFESSIONALISM OF IRS

Here, we would like to consider three issues raised by H.R. 2676: (1) freedom of IRS from political influence, (2) merit principles and personnel flexibility, and (3) the need to evaluate the consequences of the sweeping changes contemplated by H.R. 2676.

Prohibiting political influence in tax enforcement. This subcommittee is well aware that the nation's tax system must be administered by an impartial, non-political, and competent workforce. Such professional administration has not always been the case at IRS. In the early 1950s, the American public was shocked by numerous reports of IRS employee embezzlement and bribery. To halt this corruption, the Congress enacted the 1952 requirement that all IRS employees under the Commissioner be hired, trained, evaluated, and promoted under the merit system.

Experience since 1952 has demonstrated the wisdom of that congressional decision. The subsequent change in IRS' image was striking. For decades, IRS was viewed as one of the better-managed and professional agencies. The recent Senate Finance Committee hearings and the year-long investigation of IRS by the National Commission have not shown—or even alleged—the kinds of employee embezzlements and bribery that precipitated the 1952 reforms. The revealed abuses were related to overzealous efforts to collect money for the Treasury, not to put money in the employees' own pockets. So we urge that this bill continue to stress the importance of a non-political, highly qualified workforce.

We strongly support the prohibition in Section 104 of any attempt by some future President or other Executive Branch official to influence tax audits or investigations. Some of the recently released "Nixon tapes" reveal his anger and frustration over the fact that he had been unable to get IRS career personnel to audit taxpayers whom he regarded as his political enemies, and that he wanted to get a new Commissioner who would bend the career people to his wishes. There have been reports suggesting that similar efforts were made by other presidents or White House staff as well.

We believe that the prohibition on influencing tax audits is so significant that the Congress ought to extend it to cover all political appointees in the Executive Branch except for specified officials, such as those in appropriate posts at the Justice Department, whose official functions would require such involvement. In addition, we respectfully suggest that similar provisions be applied to the legislative branch.

Merit principles and personnel flexibilities. We recommend that Congress strengthen the provisions to assure that merit principles are applied to the hiring of all IRS employees below the level of Commissioner. Otherwise, over time, the agency is likely to be offered a remarkable array of politically well-connected, but marginally qualified, people for positions that were intended to be filled by experts.

H.R. 2676 provides an excellent opportunity to take further steps toward fulfilling the congressional intent of the Civil Service Reform Act of 1978. That legislation was designed, on the one hand, to encourage development of a far simpler civil service system which provided agencies and managers with the flexibility to modernize federal human resource management so the federal workforce could be more responsive to contemporary challenges.

On the other hand, the Congress also included among the 1978 reforms a series of provisions designed to prevent the new flexibilities from being manipulated in ways that undermine the principles of a professional workforce chosen on merit and protected from politicization. Such protection is of the utmost importance in administering our tax laws.

A set of merit principles was included in the 1978 law, together with a Merit Systems Protection Board (MSPB) and Special Counsel, to guard against violation of these safeguards as well as to prohibit discrimination. These provisions were included because of earlier experiences when the lack of safeguards permitted the positive steps of streamlining federal operations to be manipulated in ways that brought political intervention, resulting in scandal and lowered confidence of citizens in their government.

We note that the effort to shield IRS from politically-motivated actions would be strengthened by assuring that all of its personnel, including those placed in newly authorized management or specialist positions, are not hired because of their own political connections. The 1952 requirement that all employees below the Commissioner be hired on merit has worked well, and we recommend that it be retained in this bill. We, therefore, urge that Section 7804(a) of the bill be amended to require that all such employees: (1) be selected on a non-political and non-partisan basis; and (2) be selected strictly on the basis of merit and qualifications.

In a number of panel reports, the Academy has urged that federal personnel rules be made more flexible, as contemplated in the civil service reform law. [4] Therefore, we were glad to see that the House bill provides such flexibilities. And, we strongly support the provision that these authorities must be exercised in a manner consistent with merit system principles.

We recognize that IRS, from time to time, needs to hire experts from the private sector in such fields of expertise as information technology and customer service. But many federal agencies, including IRS, itself, as well as NASA, FAA and the Defense Department, have already demonstrated that such experts can and should be selected and hired on a merit basis. Indeed, some agencies have found that political pressures to hire marginally qualified or even unqualified people sometimes can be avoided only by requiring merit hiring. Since tax policy responsibilities will remain with Treasury Department officials, we think such new hiring should, like all other IRS employees, be carried out on a merit basis.

To be sure a proper balance is maintained between using the new flexibilities and observing merit principles, we urge that Section 9301(a) be revised. It must make clear that the organizations with responsibility for dealing with violations of merit principles through appellate and oversight processes under the 1978 civil service reform and earlier legislation (MSPB and its Special Counsel, as well as the Office of Personnel Management (OPM)) still retain this responsibility with respect to IRS.

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[4] E.g., "Revitalizing Federal Management: Managers and Their Overburdened Systems," Report of an Academy Panel, 1983, and "The Role of the Office of Personnel Management," Academy Standing Panel on the Public Service, 1991.

The need to evaluate the consequences of H.R. 2676. The Congress is developing legislation that, in its current form at least, would fundamentally change IRS, and the agency's performance. Therefore, an organized independent evaluation of these changes and their effectiveness should be planned. The evaluation should be conducted once the changes are in place, and sufficient time has elapsed to measure their effects, for two reasons.

First, it will be important to see whether the changes are achieving the objectives sought by the Congress —and if not, why not. The good intentions of the legislation may be thwarted by the unintended consequences that so often bedevil public administration. An evaluation would allow the Executive Branch and the Congress to take corrective action.

Second, several of the changes may provide lessons for other agencies. A thoughtful evaluation will allow the Executive Branch and the Congress to determine which lessons are specific to IRS and which could be generalized.

If a comprehensive evaluation is desired, it will be important to authorize it in the current legislation. The evaluation needs to measure agency performance both now and after changes have been adopted, using a common set of metrics. Equally important, it must start with the objectives sought by the Congress, understood not in the imperfect mirror of hindsight, but with the freshness and accuracy that only contemporary involvement can provide.

REORGANIZING A LARGE AGENCY IS FRAUGHT WITH PITFALLS

We have read with great interest Commissioner Rossotti's Fact Sheet describing his plan to modernize IRS, and his letter to Chairman Horn. We have also met with the Deputy Commissioner, who explained to members of the National Academy's Standing Panel on Executive Organization and Management the purposes and principal features of the modernization effort.

We applaud the Commissioner's desire to put in place reforms that will overcome or mitigate identified deficiencies in the way in which this large and vital agency functions. Rapid changes in technology alone make it imperative that IRS adjust to take advantage of the opportunities to expedite the handling of returns.

Fellows of the National Academy have been involved in most of the major reorganizations which have taken place since the first Hoover Commission (1947-1949). That experience leads us to give this advice to the Congress and to the Commissioner. We urge that legislation dealing with the internal structure and management of IRS be confined to matters of policy and the governance of the tax collection agency. The Congress should refrain from the detailed prescription of the agency's headquarters or field structure. The Commissioner has indicated the complexity of the changes he is considering. He has also stated in his letter to Chairman Horn that, "Much study is required to validate this modernization concept and to decide on hundreds of details."

It has been our experience that few major efforts to reform large agencies escape the need for significant adjustments. Thus, any legislation that prescribes the internal structure of the IRS is more likely to place impediments in the way of needed reforms than to facilitate them. The Department of Transportation Act, as overwhelmingly approved by the Congress in 1966, provides a good model. That legislation created the department and placed in it such major entities as the Federal Aviation Administration (FAA) and the Federal Highway Administration; but it did not go beyond providing for the administrators and their deputies. This approach has enabled the Department of Transportation and its components to adjust, from time to time, to changes in practices, priorities and technology.

Our advice to the Commissioner in proceeding with his modernization concept is to "look before you leap." Hence, our enthusiasm for his recognition of the need for further study of what he has proposed. Changes in the organization and systems of management of Federal agencies are inevitable, and this is certainly true of IRS. But reorganization involves costs as well as benefits. Employees must be retrained and must learn to cope with new approaches to their work and new relationships. Offices may have to be relocated. The users of the agency's services have to be informed of all aspects of the changes that will affect them. Major changes in large agencies also require several years to plan and implement, during which time management must cope with, one hopes, temporary losses of productivity.

We give this advice not to discourage needed reorganization, but to emphasize that it is essential that management assure itself that the changes are really needed, that they are the best that can be effectively implemented, and the benefits will clearly exceed the inevitable costs. Careful analysis and planning and pilot-testing should precede the commitment to proceed with an agency-wide reorganization.

An example of the total reform of a major sub-cabinet agency which was successfully designed and implemented was that of FAA in 1963-1966. In this instance, an over-centralized agency divided into "stove-piped" bureaus was adding several thousand employees per year and still having difficulty coping with the growth in aviation activity. A study was launched by the agency's Office of Management Analysis which concluded that the bureaus should be abolished and the bulk of operations delegated to a new group of regional directors. The plans for these radical changes were subjected to review and comment by both headquarters and field officials. This was followed by a three day conference of top officials of FAA.

When the Administrator decided that the decentralization should proceed, FAA established a new region to test the key elements of the reform. When the test proved successful, regional directors were chosen for five additional regions. Next, the bureaus were replaced by staff "services" and several hundred headquarters positions were abolished or moved to the field. The entire process was closely monitored by the agency's strong management analysis staff and agency orders and practices were revised to reflect the decentralized mode of operations. Four years later, the regional system was still being fine-tuned, but the resulting efficiencies had permitted the down-sizing of the agency from 45,000 to 41,000 employees, without compromising the quality of its operations.

By contrast, in our National Academy studies, and in our work with various agencies, we have encountered a number of instances in which haste in seeking to reorganize an agency has resulted in a disappointing outcome. Recent examples are abolishing the regions of the Department of Housing and Urban Development, the former Department of Health, Education, and Welfare and the Corporation for National Service. The unfortunate lesson here, Mr. Chairman, is that there is no agency in the Executive Branch so poorly organized or managed that a badly conceived or implemented restructuring cannot make it worse.

We believe it is essential that the pending legislation refrain from addressing the details of internal organization for IRS. Further study and pilot-testing may dictate the need for changes that could be barred by the provisions in statute. Such a legislative straitjacket would ill serve the agency, the public and the Congress.

CONCLUSION

We applaud the efforts of the National Commission and the Congress to reform IRS. We note that IRS is already undergoing substantial change under the direction of its new Commissioner. We believe that you should give the agency and its new leader an opportunity to show what they can do. Creating a governing board at this time (regardless of what it is called) can only delay the pace of progress and confuse responsibility and accountability.

In earlier legislation relating to agency governance structures, the Congress decided wisely to create advisory type boards for the Social Security Administration and the Resolution Trust Corporation, instead of governing boards. We strongly believe that the current reform efforts will be seriously compromised unless the Congress makes the same arrangement for IRS.

Following are ten principal changes that we believe need to be made to H.R. 2676, as it has been ordered reported by the Senate Finance Committee, to help assure that the broad purposes of the legislation can be accomplished:

- Convert the Oversight Board to a board that is advisory, rather than governing, in nature by deleting its approval powers, as well as the power to transmit IRS' budget.

- Eliminate the board's explicit power to recommend the Commissioner's removal.

- Vest in the President the power to name the board's chair.

- Require board meetings once a quarter rather than monthly.

- Make the detail of personnel to the board subject to the Commissioner's discretion, and delete the board's authority to procure temporary and intermittent services.

- Restate the continued authority of today's oversight and appellate agencies to assure the preservation of merit principles for all personnel actions, not just those taken pursuant to the new flexibilities granted.

- Preserve the "120-day" rule for the Senior Executive Service, with an exception allowed for only the Deputy Commissioner.

- Provide that the board shall be terminated after five years unless extended by statute.

- Commission an independent evaluation of the functioning of the board and the other innovative features of the bill.

- Delete the legislative prescription for a new organizational structure and encourage the Commissioner through report language to proceed cautiously and methodically toward developing and testing a structure that will enhance customer service while preserving efficiency and effectiveness.

Only with such changes do we believe that IRS, even under a strong Commissioner with long experience as a manager, will be able to measure up to your expectations.

Mr. Chairman, this concludes our statement. We will be glad to answer any questions.

Mr. HORN. Well, we thank you. What I want to do now is try out some of your ideas on some of our other panelists. We will start with Mr. Tucker.

As I remember, you suggested on behalf of your panel the Under Secretary of Taxation as a possibility. As you heard me say, my worry there is that in the hierarchy, another level is being interposed between the Commissioner—who knows what's going on—the 102,000 employees that essentially he is responsible for managing, the Deputy Secretary of the Treasury, who is the No. 2 person, and the Secretary of the Treasury.

I've seen this expansion of bureaucracy throughout Cabinet departments, I've watched them since I was in the Cabinet Department in 1960, and we had a very small staff. Commissioners did see the Secretary, and I just think that we have got a problem here when we're interposing more people, more special assistants, more people at the staff level and not enough worker bees, and the worker bees are in the Internal Revenue Service. I realize that it sounds like a good idea, but I just wondered what our friends from the National Academy of Public Administration have to say about the creation of an Under Secretary for Taxation.

Mr. STANTON. Mr. Chairman, I believe we would echo your sentiments completely. This is what Paul Light has referred to as a process of thickening of government. This kind of organizational problem is very difficult to solve in the rigid language of legislation. I would also add that a lot of it would appear to be personal relationships. One member of the academy, Sheldon Cohen, former Commissioner of IRS, served at a time when there were very good relations between IRS and the Treasury, and in fact those relations worked well because of the people involved and mutual respect involved. There wasn't much that legislation could have added to that kind of relationship.

Mr. HORN. Mr. Jasper, do you have any thoughts on this?

Mr. JASPER. Yes. I guess I would endorse both what you've said and what Mr. Stanton has said. I think that the Congress is in danger of overreacting to the quite serious problems with respect to IRS performance in numerous ways. We are going to create an oversight board; we are moving the Inspection Service substantially to the Treasury Department under the Senate bill; we are increasing congressional oversight; and now we're talking about adding yet another layer of supervision between the Secretary of the Treasury and the Commissioner. I think the Congress has already gone too far, as we've said in our prepared statement, in terms of overkill with respect to what's needed to reform the IRS. The reforms are probably going to prove to be worse than the disease.

Mr. HORN. Well, let me raise the Inspector General issue. Should there be an Inspector General within the Internal Revenue Service or should they simply depend, as they do now, on the Inspector General of the Treasury?

Mr. JASPER. I think the right answer is to retain the Inspection Service in the Internal Revenue Service, perhaps strengthening it, perhaps redefining it. It is in effect their counterpart of an Inspector General function. But the Inspector General function, as you well know, is already controversial in the sense that it divides accountability between the head of the department and the Inspector

General, who has his or her separate reporting channel to the Congress. The IGs have financial audit function, thus depriving the head of the agency of a valuable tool of internal management, that is, auditing. So I think that the IG model is not necessarily a solution to all of our problems. I therefore would suggest that strengthening, perhaps increasing the autonomy to some degree, of the Inspection Service within the IRS is a better answer than moving it to the Treasury Department.

Mr. HORN. So you would have the Inspection Service remain in the Internal Revenue Service, but you're not favoring an Inspector General solely for IRS. You're saying let the Treasury Inspector General deal with IRS as just another constituent department, even though they've got 102,000 employees.

Mr. JASPER. My feeling is that the Inspection Service of the IRS should be strong enough to provide most of the independent inspection, audit, and oversight that is required. If in a rare case the Inspector General of the Treasury Department needs to look at the IRS, just as that Inspector General would look at some other bureau or administration of the Treasury Department, so be it; but I don't think the IG of the Treasury Department should have a special section just devoted to the IRS.

Mr. HORN. Mr. Mares, what do you think about the idea of an Under Secretary for Taxation and where the Inspector General should be?

Mr. MARES. I think, first of all, that there is a lot of validity to the concern about Treasury oversight. Over the past few years, Treasury has not done as thorough or as good of a job I think as they could have done in supervising and oversight over the Internal Revenue Service. I share your concerns, the concerns that I've heard here this morning, about how exactly that function would operate, if you have a line of communication through the IRS, through an Under Secretary, up to the Secretary.

But I think also another factor needs to be considered, and that is how this proposed position will impact the oversight board, because with an oversight board and with perhaps an Under Secretary of Treasury and with the proposed, at least the House version of the bill has the Secretary of the Treasury on the oversight board, does that bypass the need for an Under Secretary? So I think you've got to look at both what the reform proposals would be perhaps, once they're finished, to determine whether or not an Under Secretary would be a good idea. But there is some validity to the concerns expressed for that position.

Mr. HORN. Mr. Tucker, as the last respondent to this question before I yield to Mr. Kucinich, what's your best shot in saving that idea?

Mr. TUCKER. And as the proponent for this idea. First of all, Sheldon Cohen is a good friend, a former Commissioner, but I would recall that he was the Commissioner in a different world. At that time of the world that he was in, our real concerns abroad were the Vietnam War and whether Russia was more stable than we were, in terms of enabling it to conquer the world. Today our concerns are international fiscal policy and the international business world and the G–7, and the Deputy Secretary of the Treasury has a lot of responsibility for that, as does the Secretary of Treasury. You need somebody who is directly on line with the responsibility, and I fear that a Secretary of Treasury himself or herself cannot do it all. You need somebody who reports directly to that person as his or her agent and representative, and that's our position as to the Under Secretary for Taxation. You need somebody with real responsibility at the Treasury.

Mr. HORN. We thank you, and now 10 minutes to——

Mr. JASPER. Could I add one quick word?

Mr. HORN. Go ahead.

Mr. JASPER. Perhaps the solution that would meet Mr. Tucker's objectives would be simply to upgrade the Assistant Secretary to an Under Secretary and thus avoid the layering problem.

Mr. HORN. There, though, you're talking about the Assistant Secretary for Tax Policy, which doesn't pretend, which shouldn't pretend to know a thing about human organization or anything else. They're sitting there on tax policy, aren't they?

Mr. JASPER. That's presumably correct.

Mr. TUCKER. We agree. We would keep that in place. We think that they are not responsible for tax administration and ought not to be. Policy is quite different from administration.

Mr. HORN. Right. I wish you would get a few deans of policy schools to understand that so they would teach both.

My colleague from Ohio, 10 minutes for questioning.

Mr. KUCINICH. Thank you very much Mr. Chairman.

I'd like to return to Mr. Tucker for some questions about the constitutional objections which were raised in your written testimony about an oversight board with governing authority over the IRS. Could you elaborate on your constitutional concerns?

Mr. TUCKER. Yes. We believe that there is under the Constitution a concept of separation of powers, and that separation of powers looks at the executive branch with the Internal Revenue Service and Treasury Department focused on the executive branch, and they have responsibility for the administration of the collection of taxation in this country. They don't, unfortunately, have the full responsibility for the passage of laws that they have to administer, but they do have responsibility for administration.

We think that the board, which would be a congressionally mandated board, ought not to be the party that is micromanaging and that in effect is usurping or potentially usurping those powers. We are concerned that, as Mr. Stanton has said, this be an oversight advisory board. We think, just as in the case of the Social Security Administration, you have something that clearly could work with a proper sunset and ability to review it, but we think that this concept of the collection of our revenues, the administration of that ought to be within the executive branch.

Mr. KUCINICH. Since you raised these constitutional issues, could you provide this committee with any case law citations that would be instructive as to why, constitutionally, such a provision to establish governing authority over the IRS would not pass muster?

Mr. TUCKER. We will be pleased to come back to you with citations.

Mr. KUCINICH. I think it would be helpful, because certainly we in the legislative branch always want to be mindful about the constitutional issues and your constitutional objections to forming an oversight board with governing authority is something that I think is noteworthy, as well as we certainly—the idea of an advisory board is a whole different thing, I would assume. How do you feel about that, Mr. Mares, again? You know, do you see—do you share concerns about governing authority versus advisory authority?

Mr. MARES. I think those are legal issues, and I'd leave that to the discussion by the ABA. I do think, though, that our concern about the oversight board, which is expressed in our written comments, is that this board needs to have a strategic view, not a day-to-day affairs view, and I think that we agree with our colleagues on the section of taxation.

Mr. KUCINICH. I think your point is well taken because if—and it's complementary to what Mr. Tucker has outlined, the idea of strategic planning can always be enhanced with an advisory from an advisory position. But it would be counterintuitive to have a supervisory position or in effect a governing authority because, as you stated in your testimony, you could be at cross purposes. You could be creating a war in camp without full constitutional authority. It could raise some questions that might undermine the IRS, I would assume.

And when we heard the testimony from Mr. Rossotti earlier, where there is an effort to put forth some management principles that would be part of an overall reform of the IRS, it would seem to be unwise to proceed in an area of governing oversight until we can see if the Commissioner can work his plans.

I guess my opinion, as a member of this committee, would be give the Commissioner an opportunity to work his plans for restructuring and reform. If that fails, then we can look at some other possible remedies. I want to thank the gentleman for appearing before this committee today, and the Chair for calling this meeting, to give the American people an opportunity to look at this sometimes mysterious system of income collection and the way the IRS operates.

So thank you, Mr. Chairman, I appreciate being here.

Mr. HORN. Well, we thank you for your very good questioning. And let's pick up one point you noted earlier, and I certainly agree with you. That is the point that every local sheriff or tax collector in America usually publishes the defaulters on property tax in the local paper. And I guess the question I would ask of you professionals is: Do you have a problem with us going to the Ways and Means Committee and saying, look, privacy should not protect defaulters and people that are constantly defaulting and constantly going bankrupt and milking the system, not paying their employees, not putting the trust funds in Medicare, not putting the trust funds in Social Security, et cetera? How would you feel about doing just what the local sheriff does and printing a list in the Federal Register, and if the Washington Post or the San Juan Battista Mission News, no longer in existence, wants to publish it, they're free to publish it? How about it, Mr. Tucker?

Mr. TUCKER. Let me note that at the local level, if a corporation is a titleholder to real property, it is the name of the corporation that appears in the public record. You don't look through to what we would refer to as "responsible officers," which is the focus of the Internal Revenue Code.

I think the problem is, as stated by the people at the GAO, that these corporations come and go. Under State law, I can have a corporation; I can dissolve, liquidate, or terminate the corporation, and publishing its name really has no effect at all because corporations are as generic as you want them to be. And my clients, who are in different real estate projects, for example, have different entities for each project because that's a creditor protection and that is an asset protection that the creditors look at. So that's one issue. The "responsible officer" is something unique to the Internal Revenue Code.

For example, if I have a State obligation to the State of Maryland for taxes from a corporation and that corporation has gone under, that's where the obligation resides, just as if I have a Federal obligation on behalf of a corporation to the Internal Revenue Service, that's where the obligation resides. The issue is the trust fund. The responsible officer has responsibility for the trust fund. They have withheld money from an employee that is owed to the Federal Government, and they're responsible for that as responsible officers.

I will share with you that many people are thought to be responsible officers, who may not be responsible officers, and that's an issue within the Internal Revenue Code. I'd have no problem with publishing the names of all these corporations. I think, quite frankly, it could be an exercise in futility. I think it's the responsible officers that you may want to look at, but first you have to make certain that they really are. And I think the biggest issue is the failure to pick up the returns and audit them timely. Too often this occurs, and I think that's the biggest problem we have here. If we caught the people—and I don't mean that catching is the proper term, because you say, Mr. Kucinich, that bankruptcy is too often a sham.

Mr. KUCINICH. It's Koo-sin-ich.

Mr. TUCKER. I'm sorry, Kucinich; I apologize.

Mr. KUCINICH. It appears on my IRS form as Kucinich, but it's Kucinich.

Mr. TUCKER. I'm sorry; I'm originally from your adjacent State, Michigan, not from Ohio.

Mr. HORN. Do you object to the publication of the chief executive officer of that corporation?

Mr. TUCKER. If, in fact, that person was the responsible officer, he or she is responsible. I think the biggest issue many times is the person truly the responsible officer and publishing the name of somebody who might not have been that person, I think is an invasion of privacy.

Mr. HORN. Well, if they're the chief executive and they knew that if they default and do some of the nonsense that goes on in these small corporations around the country—these aren't huge corporations, these are small corporations, restaurants, you name it, nonprofit groups, where I've seen them not pay their proper withholding to the IRS, and that hurts, obviously, the individual. It means the rest of us, as taxpayers, have to make that up from the general fund when they didn't take their 15 percent for Social Security or their 3 percent for Medicare, whatever it is. Why shouldn't the CEO and the treasurer or the budget officer publish all of them, because one of the three had to be in on it, or had to know, and it seems to me the public has a right to know who the defaulters are.

Now what do you think, Mr. Tucker?

Mr. TUCKER. I think the comment you made that one of the three had to be in on it may be accurate, but what about the two out of the three that weren't in on it? OK. And is publishing their names appropriate in that situation? Again, if we did the review more quickly, if we did the assessment more quickly, we knew who the responsible officers were, and then we went after them, I have no problem. My problem is just blindly putting in there the ability to publish any name and any situation.

Mr. HORN. Well, if they're hiding behind a corporation, I think we need to reveal those names. Just as I've said earlier, we all grew up in towns where the newspaper, and we all read them—listed who hadn't paid their property taxes. Maybe they couldn't pay, maybe they had to work out something with the county tax collector. On the other hand, it didn't let them get away with anything.

Right now, these people cannot only get away with it, they can come back in and get a loan from the Farmers Home Administration. That's what I tried to stop with our Debt Collection Act, which is the law of the land as of 2 years ago. There's billions they should be collecting in that area. And there's an actual case, where a guy in Sonoma County defaulted on a several million dollar loan for his ranch, moves to Santa Barbara, buys his mansion up there—also Farmers Home—and a seven-story office building. You know, it's simply unbelievable. I think we've stopped that, provided the computers talk to each other within the Department of Agriculture or between agencies, so you can know when that person is applying for a government benefit. Anyhow, that's one issue.

Does my colleague have any more questions?

Mr. KUCINICH. I would say I look forward to working with the Chair on this particular point because, while again we have to respect privacy concerns, taxpayers of this country are getting ripped off for billions of dollars from people doing it deliberately; you know, not people fallen on hard times—we grieve for those same people—but people who set out as a matter of business.

Corporations under the law, as you know, are treated in most court cases as individuals, but they can suddenly appear and disappear, unlike individuals, and then reappear again as though they were reincarnated. We mortals don't have that opportunity, but corporations do. So when you consider that, this might be time, Mr. Chairman, to look at revision in the code, and I certainly would look forward to working with you on that and congratulate you for the work that you have done in the previous matters.

Thank you.

Mr. HORN. Let me just ask one closing question. I don't want to embarrass you professionals, but we have two choices that are being given to us, and people are going around the country trying to educate the people on the choices. One is the 17 percent across-the-board approach of the majority leader, Ph.D. in economics, Mr. Armey of Texas. Another is the consumption tax, which is the approach of the distinguished chairman of the Ways and Means Committee, Mr. Archer, also from Texas. Now does the individual who represents the lawyers in taxation, Mr. Tucker, wish to give us what his best shot would be on which one of those makes sense as opposed to the current system?

Mr. TUCKER. I'd be more than glad to. I have done writing and speaking on this area. We think that there is no ability to replace the Internal Revenue Code with either a consumption tax or a value-added tax of any sort. There is no civilized nation in this world that has simply a value-added tax. It's usually an adjunct to an income tax. We think our income tax system, with all of its deficiencies, with all of its defects, is the best in the world. We collect the great bulk of all of our money from taxpayers simply through the W–2 form or the 1099 form. We think that you can accomplish a lot more by simplifying the Internal Revenue Code, even if at some point you add to that a national sales tax or a value-added tax.

The other——

Mr. HORN. I don't hear anybody talking about a value-added tax. Maybe I'm missing something.

Mr. TUCKER. Well, the consumption tax is, in effect, a form of value-added taxes.

Mr. HORN. Isn't the consumption tax really a sales tax?

Mr. TUCKER. Yes, but it has enough exceptions and enough other backouts that it is a concept that's very similar to a national sales tax. That's exactly right.

Mr. HORN. The thing that upset the Governors, the State legislators, and the local mayors, all of whom have sales taxes.

Mr. TUCKER. Well, it would have to be an add-on, it would not be a replacement, and we think that that would be very detrimental.

Mr. HORN. So anyhow you're not happy about the consumption tax. Now what about the across-the-board X percent tax? I think the minority leader, democratic leader, put in 11 percent, the majority leader put in 17. And is there any feeling on that?

Mr. TUCKER. The studies that we have seen and that we concur with show that, if you were going to put an across-the-board flat tax in, it probably is going to be in the lower to mid-range of the 20's. We think a good number of the people in this country pay less than that at the present time and that the flat tax probably is not going to be beneficial. It also requires no transition rules at all, and without transition rules you have a massive impact on people in their present positions, from real estate to manufacturing and everything else. So we think that that would be a real problem.

Mr. HORN. Mr. Mares, do you have any thoughts on this?

Mr. MARES. Absolutely. About 2 years ago, we concluded a study on all the various alternative tax systems that were being discussed at that time, include the flat tax consumption tax, and a value-added tax. I'll be happy to make a copy of that study available to you because I think it illustrates——

Mr. HORN. Without objection it will be put in the record at this point.

[The information referred to follows:]

Executive Summary

Americans want fundamental tax reform and, more than ever before, the U.S. Congress is inclined to grant their wish. Many proposals now before Congress would entirely eliminate the $700 billion in annual revenue from the individual and corporate income tax.

To replace this lost revenue, a variety of new tax systems have been proposed. These new taxes come in all shapes and sizes, but they have one common characteristic. They are taxes on ***consumption*** and, as such, have the potential to improve America's international competitiveness—primarily by increasing private savings. In addition, because entirely new systems are being devised, there is tremendous opportunity for simplification.

No matter how simple the new system, however, the transition to it involves enormously complex political, economic, and technical issues. It is true that most industrialized countries have adopted consumption taxes. But these taxes, for the most part, just served as replacements for poorly functioning excise taxes. No major industrialized country has ever repealed its personal or corporate income taxes.

And nothing in U.S. history can serve as precedent. Such sweeping legislation as the Reagan tax cuts of 1981 and the income tax reforms of 1986 pale in significance compared with the proposals now being floated.

Clearly, as this nation moves closer to fundamental tax reform, it moves deeper into uncharted territory. This publication is designed to help all interested Americans begin to understand how consumption taxes will affect their economy, their businesses, and their own personal finances.

The Major Alternatives

There are many types of consumption taxes, but four are critical to understanding the current debate:

1. *Retail Sales Tax*—levied by most states
2. *Value-Added Tax*—levied by every major industrialized country, except the United States and Australia

3. *Flat Tax*—proposed by House Majority Leader Dick Armey
4. *Unlimited Savings Allowance (USA) Tax*—proposed by Senator Sam Nunn and Senator Pete Domenici

Retail Sales Tax

A federal retail sales tax at first appears to be an attractive alternative to current law because individuals would no longer file tax returns. A heavy burden would, however, be placed on retailers and tax administrators, particularly if legislators provide exemptions for favored businesses and products.

Even without special exceptions, there are substantial problems, including evasion by small retailers that do not report sales and by business owners that purchase items for personal use. These problems would be particularly severe if a federal retail sales tax had rates in excess of 20 percent—which would be required to replace revenues loss from the repeal of the income tax.

A retail sales tax also faces the large political hurdles of being a highly visible regressive tax and of encroaching on the states' sales taxes. While a federal retail sales tax might be administratively feasible as a supplement to the current income tax, it does not seem likely that such a tax would be a good replacement for the current system.

Value-Added Tax

Value added is the difference between the value of a business's sales and its purchases from other businesses. A value-added tax (VAT) is a tax on businesses that is collected as goods move through different stages of production. Most value-added taxes in place throughout the world are ***credit-invoice*** value-added taxes. These taxes require firms to keep a detailed record of each sale and purchase. In the United States, there is currently little interest in a credit-invoice value-added tax.

One alternative to the credit-invoice method of implementing a VAT is known as the ***subtraction*** method. The subtraction method is widely considered to be simpler than the credit-invoice method because such taxes may be implemented without new recordkeeping requirements and may instead use existing books and records. The two leading alternatives now being considered for the United States, the Flat Tax and the USA Tax, are variants of a subtraction-method VAT.

The Flat Tax

The Flat Tax has two components: a business tax and the individual tax. The 17 percent ***business*** tax is imposed on all businesses, not just corporations. The business tax base is business receipts reduced by (1) wages and (2) purchases from other businesses. Under this new tax, the entire cost of new plant and equipment may be deducted in the first year, and overseas subsidiaries of U.S. businesses are exempt from tax. These advantages to businesses are offset by the loss of deductions for interest payments and for fringe benefits.

Under the ***individual*** Flat Tax, a 17 percent tax is imposed on wages and pension distributions. Interest, dividends, and capital gains are exempt. Large personal and dependency exemptions would remove tens of millions of taxpayers from the tax rolls. Under proposed Armey legislation, a family of four would be subject to tax only for wages in excess of $31,000.

Except as described above, the Flat Tax has no other deductions or credits. Most notably, there are no deductions for home mortgage interest, charitable contributions, state income taxes, and property taxes.

It is important to recognize that with a 17 percent rate, a Flat Tax that replaces current income taxes would likely be a large revenue loser. Some economists have argued that a Flat Tax rate of at least 23 percent would be required to avoid revenue losses.

The USA Tax

Like the Flat Tax, the USA Tax has a business tax and an individual tax. The USA ***business*** tax has a rate of 11 percent and is imposed on ***all*** businesses. Also, like the Flat Tax, the entire cost of new plant and equipment may be deducted in the first year and overseas subsidiaries of U.S. businesses are exempt from tax. There are three key differences between the USA and Flat business taxes. Under the USA business tax, (1) the deduction for wages is replaced with a payroll tax credit in the amount of 7.65 percent of most wages, (2) exports are exempt from tax, and (3) an 11 percent duty is imposed on imports.

The USA ***individual*** tax has graduated rates up to 40 percent. For a family of four the 40 percent rate could apply to incomes as low as $41,000. Unlike the Flat Tax, there are deductions for charitable contributions and for mortgage interest. There is also a new deduction for income that is saved. In addition, individuals get a 7.65 percent tax credit on most wages.

The Big Policy Issues

Impact on Saving and Economic Growth

There is no dispute that saving is critical to economic growth. Saving provides the funding for capital formation that gives U.S. workers the tools to be more productive and competitive. There is also no dispute that the U.S. rate of saving is low whether compared with other countries or with past U.S. rates. The replacement of the current U.S. tax system with a consumption tax would increase the after-tax return to capital and would eliminate the bias inherent in the current tax against capital formation.

There is dispute, however, as to how much such tax changes can increase private saving. Even under the most optimistic set of assumptions, it is unlikely that a switch from an income tax to a consumption tax can increase the rate of U.S. saving to a level comparable to that of its major trading partners.

Nevertheless, even modest changes in the rate of saving can have a positive impact on economic growth over the long term. Thus, although there is a high degree of uncertainty, legislation that would replace the current income tax with a consumption tax has significant upside potential from the standpoint of promoting U.S. competitiveness.

Balance of Trade

Most consumption tax systems exempt exports and impose tax on imports. (The Flat Tax is an important exception to this rule.) Although these "border tax adjustments" are often perceived as beneficial to a nation's balance of trade, there is broad agreement among economists that these adjustments are unlikely to have any significant impact on trade. Consumption taxes can, however, improve the trade balance to the extent they are able to increase domestic saving.

Redistribution

Consumption taxes are widely perceived as placing an undue burden on the poor and elderly. Any politically realistic consumption tax will likely be supplemented by features to alleviate the burden on low-income households.

Most of the states with retail sales taxes and other countries with value-added taxes exempt necessities such as food, clothing, and health care from the tax base, with the intent of reducing the tax burden on the poor. The exemption of necessities, however, is not particularly effective in mitigating the regressivity of consumption taxes.

Some form of tax credit or standard deduction will likely play an important role in alleviating the regressivity of any new consumption tax enacted into law.

Simplification

The proposed new consumption taxes have tremendous potential for simplification. This is particularly true because under the proposals some of the more complex areas of current law—namely the tax treatment of pensions, of international income, and of corporate acquisitions—become obsolete.

New tax systems, however, may entail new compliance requirements that add complexity. For example, the USA Tax must have complicated rules to determine "new" saving that is eligible for deductions, and under the Flat Tax, businesses must be able to differentiate between business expenses (which are deductible) and fringe benefits (which are not deductible).

In addition, much of the complexity of the current tax code is attributable to dozens of targeted tax benefits. Proposed tax laws often appear simpler than existing taxes because existing law has been subject to successive legislative amendments that add complexity. It is highly probable that any new consumption tax would accrete substantial complexity (at the outset as well as in subsequent legislation) as Congress found it necessary to provide tax relief for a variety of taxpayers. Finally, there will be costs to government and taxpayers of transitioning from one system to another.

Transition

Without special transition rules, the replacement of an income tax with a consumption tax would haphazardly subject many individuals and businesses to large tax penalties. In the absence of transition relief, saving and investment done prior to enactment would have to pay significantly higher tax than under prior law. (In contrast, new saving and investment would be tax-free.) These retroactive tax increases would unfairly burden not only elderly individuals who are no longer saving, but also mature businesses that are no longer investing. In addition, without adequate transition relief, tax reform proposals could have a large and significant impact on the financial statements of many firms.

Transition relief is expensive both in terms of lost revenue and in terms of administrative and compliance costs.

Inflation

A consumption tax is unlikely to have any sustained impact on the rate of inflation. There may, however, be a onetime impact on the overall price level if the Federal Reserve responds to the tax change with an expansion of the money supply.

The Impacts on Different Types of Businesses

Corporate Businesses

In general, under both the Flat Tax and the USA Tax, labor-intensive firms—such as those in the construction, service, and transportation sectors—bear a greater share of the total corporate tax burden than they would under the current corporate income tax. Capital-intensive industries—like those in the communications and public utilities sectors—are likely to pay less taxes.

The exclusion of exports from gross receipts provides large tax benefits to those firms that export. For a typical manufacturing exporter, the exclusion of exports available under the USA Tax can easily cut a business's tax liability in half. In contrast, the Flat Tax does not exempt exports.

Noncorporate Businesses

Both the USA proposal and the Flat Tax impose new tax burdens on noncorporate businesses. For a typical small business, the USA Tax imposes a greater business tax burden than the Flat Tax.

One way of assessing the impact on noncorporate business is to compare the combined individual and business tax burdens before and after the imposition of a new consumption tax. The combined burden for the owners of unincorporated businesses under the Flat Tax appears to be less than under current law. In contrast, the total tax burden under the USA Tax appears to be greater than current law, particularly for high-income owners of unincorporated businesses whose compensation would be subject to a combined business and individual tax rate in excess of 50 percent.

The Impact on Individuals

Relative to current law, the USA Tax generally provides tax relief to low- and high-income taxpayers, and a modest tax increase to middle-income taxpayers.

The Flat Tax appears to provide tax relief to nearly all individual taxpayers (except those low-income households receiving refunds under current law from the earned income tax credit). This tax relief is particularly large for high-income taxpayers because interest, dividends, and capital gains are exempt from tax.

Some Important Details

Housing

In most other countries with consumption taxes, new housing is subject to tax and existing housing is exempt. Under both the USA Tax and the Flat Tax, new residential construction is subject to business tax.

Under the individual Flat Tax, the elimination of the deduction for mortgage interest (along with the loss of deductions for property taxes) adversely affects homeowners. Under the individual USA Tax, which allows deductions for mortgage interest, housing continues to enjoy its tax-favored status.

Banking, Insurance, and Other Financial Service Providers

Because it is difficult to identify and value services provided by financial institutions, no other country with a consumption tax has been able to properly tax financial services. Any rules that can be devised to include financial services in a new U.S. consumption tax are likely to be extremely complex and—if not carefully formulated—could significantly impact the competitive balance among various financial service providers.

State and Local Governments

State and local governments could suffer financial hardship if their taxes are not deductible against federal tax—as is the case under both the Flat Tax and the USA Tax. In addition, a new federal consumption tax might encroach on the states' ability to levy their own sales taxes. Repeal of the federal income tax will surely complicate administration of state income taxes.

Charitable Organizations

Under some tax reform proposals, donors to charitable organizations lose the benefit of deductions for contributions, and the charitable organizations themselves are liable for tax on their activities.

Estate and Gift Taxation

It is an open question whether estate and gift taxes would be retained or repealed under any tax reform proposal enacted into law. The Armey Flat Tax repeals estate and gift taxes. The USA Tax retains the current estate and gift tax structure. (The USA Tax also amends current law by replacing tax-free stepup basis with carryover basis at death.)

Conclusion

As much as lawmakers may want to satisfy the public's desire to eliminate the income tax and replace it with a simple tax, there are no easy solutions.

There are unresolved questions concerning the impact of these tax changes on saving, productivity, trade, interest rates, and inflation. There is debate about the compliance and administrative costs of these new proposals and about the amount of revenue they raise. There are a host of unresolved technical issues—transition relief, banking and financial products, and housing.

Finally, there are numerous political issues that have not even yet begun to sort themselves out because so few taxpayers understand the impacts of the proposed new taxes. There is, of course, the age-old issue of rich versus poor. And, if that were not enough, politicians must still address concerns surrounding redistribution of the tax burden from the young to the elderly, from low-tax to high-tax states, from capital-intensive to labor-intensive industries, from exporters to importers, and from corporate to noncorporate businesses.

Mr. MARES. I think that that study illustrates some of the issues that Congress has to look at when dealing with any alternative system. Transition rules are a huge issue that have to be addressed. For example, in transitioning to a sales tax type of arrangement, is it fair for divorced couples, who have arranged their financial affairs based on the payment and deductibility of alimony, suddenly to lose that? Is it fair for individuals, who have purchased houses on the assumption they will be able to deduct the interest and real estate taxes, to lose that?

So there are tremendous transitional issues if you go from an income-based system to a consumption tax-based system. On the other hand, when you look at the flat tax, again the studies we have seen show that the rate has to be in the mid 20-percent range, and that raises a number of issues about who is going to be a winner and who is going to be a loser under that. Do you lose regressivity, and is that something that is desirable?

So I think our position is that before we decide to change the tax system and sunsetting the Internal Revenue Code before we have a system in place would be a terrible mistake, in my opinion. Before we change the system, we better understand the advantages of any new system and we better be sure we understand and can deal with the disadvantages of that new system.

Mr. HORN. Well, I'm going to get to you gentlemen, believe me. I just want to say so far, on behalf of the tax lawyers and the tax accountants, when I was on the Senate staff 38 years ago we—I remember during the Kennedy administration—had a tax bill and we started calling it the Lawyers and Accountants Tax Relief Act of 1962. Then you could put in 1986 and you could put in what we did 2 years ago—because heaven knows people had trouble with schedule D, and I sure heard about that—that's why I said we ought to all go fill out our own tax forms, maybe it would make it simple.

I've got one simple criterion on whatever they decide on in the leadership and the Committee on Ways and Means that has jurisdiction, and that is if it adds $1 to the national deficit, I'm against it. So they're going to have to have enough money to cover what we do. On the other hand, we ought to be cutting another $50 or $100 billion out of the budget of the executive branch of the government and tighten up more, because it can be done; it just takes some willpower.

Now what do the distinguished representatives of the National Academy of Public Administration have to say?

Mr. STANTON. Well, Mr. Chairman, there will be the same management problems for these new kinds of taxes that we have for the old. It is unlikely that the Congress and the tax-writing committees in fact will refrain from embellishing any flat tax or any value-added or sales tax with deductions. The mortgage interest deduction is already being mentioned in conjunction with the flat tax. In the end, there will be tremendous administrative problems with these taxes. You don't solve anything by setting a flat tax rate, for example, in deciding whether the use of a home office is properly allocated for home or business purposes when applying that tax. There are a number of issues that will continue to be there and will continue to require somebody of the quality of Commissioner Rossotti and a tremendous amount of hard work on the management side.

Mr. HORN. Professor Jasper, any thoughts on this?

Mr. JASPER. Just to quickly add that, as you suggested earlier, if Members of Congress had to fill out their income taxes themselves, they would have a greater appreciation for tax simplification. I think tax simplification is what is needed, not a wholesale change in the nature of our taxation. The Congress enacted the Taxpayer Relief Act last year with changes that are to be implemented over a period of, I think, as much as 5 or 6 years into the future. This means that every year taxpayers are going to have to figure out what happens this year, what happens next year; and this is on top of finding that the IRS has difficulty in keeping up with the Tax Code as it was before the Taxpayer Relief Act. It's time to draw a line, simplify the Tax Code, not make it more complicated, or not look for illusory alternatives.

Mr. HORN. Well, I'm glad we got your statements on the record, and those who read the record will know where you stand. I'm not sure any of us in Congress know where we stand, but we're trying to build a consensus in this country to do either option or a combination of things. The latter is more likely because we've taken millions off the tax roles, as you know, starting in 1986. Most people in lower income don't pay any taxes. Indeed, they can go in and file for the Earned Income Tax credit, which is filled with fraud, among other things. We've got a long way to go, in getting public understanding on this. But Mr. Archer, Mr. Armey, and Mr. Tauzin of the Ways and Means Committee, will certainly be spreading the message around the country to get people aroused one way or the other and thinking about this—that's the important thing. What is the best combination that helps us have a lean government, but also pay the bills so we don't run up these unbelievable deficits which are now $5.3 trillion, if I remember.

So if there are any other comments any of you would like to make? If not, I thank you all for your time and coming and sharing your thoughts with us; they are immensely helpful. With that, this subcommittee is recessed until tomorrow morning.

[Whereupon, at 12:40 p.m., the subcommittee was adjourned.]

[Additional information referred to follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAY 12 1998

The Honorable Stephen Horn
Chairman
Subcommittee on Government Management,
Information, and Technology
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The following comments are offered for the record of hearings on the audits of the financial statements of the Social Security Administration, Health Care Financing Administration, Department of Defense, and the Internal Revenue Service for the Year Ended September 30, 1997.

The Office of Management and Budget (OMB) has been and continues to be a strong supporter of agency audited financial statements as a principal means of demonstrating financial accountability. OMB demonstrated this in 1990 with its support for the passage of the Chief Financial Officers Act of 1990 and again in 1994 in passage of the Government Management Reform Act of 1994. The goal of timely financial statements with unqualified opinions from the auditors has been clearly articulated in the Federal Financial Management Status Report and Five Year Plan published jointly by OMB and the CFO Council. Most recently, this commitment was reiterated in the President's Budget for fiscal year 1999. The 1999 Budget stated the Administration's goal of obtaining an unqualified auditor's opinion on the consolidated financial statements of the Government of the United States for the year ended September 30, 1999. This is a very aggressive goal that will be extremely difficult to attain but it represents the ultimate financial accounting to the people of the United States.

Our goals cannot be met without formidable efforts by the agencies that testified before your committee on April 15, 16, 17, and 24, 1998. These agencies are responsible for the largest government programs, including Social Security, Medicare, and National Defense; and the vast majority of the government's revenue collecting activities. My comments, which follow, highlight the status of the audits of these agencies for 1997 and previous years and reflect the principal actions that must be undertaken by these agencies in order to achieve a greater level of accountability. We are committed to working with these agencies as necessary to ensure our collective goals are met.

Sincerely,

G. Edward DeSeve
Acting Deputy Director
for Management

Enclosure

DEPARTMENT OF DEFENSE FINANCIAL MANAGEMENT: SERIOUS PROBLEMS PERSIST

THURSDAY, APRIL 16, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Kucinich.

Staff present: J. Russell George, staff director and chief counsel; John Hynes, professional staff member; Matthew Ebert, clerk; and Mark Stephenson, minority professional staff member.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will come to order. It adjourned yesterday until today at 10.

We're here today to discuss the status of efforts of the Department of Defense to correct long-standing financial management problems.

Two weeks ago, this subcommittee held a hearing on the first-ever audit of the executive branch of the U.S. Government. We looked at their consolidated governmentwide financial statements. We learned that one of the main impediments to reliable governmentwide financial statements is the poor condition of the financial books maintained by the Department of Defense.

This subcommittee takes seriously the need to resolve these financial management problems. We have held numerous hearings exploring a wide array of issues facing the Government as a whole and the Department of Defense. Some of these issues affect the government as a whole, such as the year 2000 challenge, improving debt collection practices, and managing high-risk areas. Some of the issues are specific to the Department of Defense, such as the management of surplus military equipment.

In a hearing 2 years ago, we found that the Department of Defense reported "problem disbursements," payments that could not be matched to contractual obligations. Those problem disbursements totaled a massive $25 billion. According to the Department of Defense Inspector General and the General Accounting Office, which is the congressional arm on both program and financial audits, problem disbursements remain. We want to know the status of the Department of Defense's problem disbursements. Specifically, what is the Department doing to prevent them from continuing to occur in the future? Has the Department resolved past amounts estimated at $25 billion, as I noted?

In our April 1st hearing on the governmentwide audit, we also heard about the Department of Defense's inability to find all its equipment and inventories; and its inability to estimate and report costs for environmental and disposal liabilities. This is a factor that very few agencies are dealing with, which the General Accounting Office believes is understated by tens of billions of dollars.

Defense has also had an inability to determine the cost of post-retirement health benefits for its military employees; has an inability to report accurately the net cost of its operations; an inability to account for billions of dollars of basic transactions; and an inability to ensure that all disbursements are properly recorded and reconciled.

We will explore these issues in greater detail today. We need to know what the Department of Defense is doing to resolve these deficiencies. Regardless of their effect on the executive branch's financial statements, these problems are severe; and we cannot allow them to persist.

[The prepared statement of Hon. Stephen Horn follows:]

ONE HUNDRED FIFTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

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"Department of Defense Financial Management: Serious Problems Persist"

April 16, 1998

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management, Information, and Technology

We are here today to discuss the status of efforts at the Department of Defense to correct long-standing financial management problems. Two weeks ago this subcommittee held a hearing on the first-ever audit of the Government's consolidated governmentwide financial statements. We learned that one of the main impediments to reliable governmentwide financial statements is the poor condition of the Department of Defense's books.

This subcommittee takes seriously the need to resolve these financial management problems. We have held numerous hearings exploring a wide array of issues facing the Department of Defense. Some of these issues affect the Government as a whole, such as the year 2000 challenge, improving debt collection practices, and managing high risk areas. Some of the issues are specific to the Department of Defense, such as management of surplus military equipment.

In a hearing two years ago, we found that the Department of Defense reported "problem disbursements"--payments that could not be matched to contractual obligations. These problem disbursements totaled a massive 25 billion dollars. According to the Inspector General and General Accounting Office, problem disbursements remain. We want to know the status of the Department of Defense's problem disbursements. Specifically, what is the Department doing to prevent them from occurring in the future as well as to resolve past amounts.

In our April 1st hearing on the governmentwide audit, we also heard about DOD's inability to:

- find all its equipment and inventories;
- estimate and report costs for environmental and disposal liabilities—which GAO believes is understated by tens of billions of dollars;
- determine the cost of post-retirement health benefits for its military employees;
- accurately report the net cost of its operations;
- account for billions of dollars of basis transactions; and
- ensure that all disbursements are properly recorded and reconciled.

We will explore these issues in greater detail today. We need to know what the Department of Defense is doing to resolve these deficiencies. Regardless of their effect on the Government's financial statements, these problems are severe and we can not allow them to persist.

We welcome the witnesses and look forward to their testimony.

Mr. HORN. We welcome the witnesses that are coming here today, and we hope we will get the total picture from these witnesses. I think we will. They are the people that have been down in the trenches and know what is working, what is not working, and what decisions are being made to make sure that we improve and not simply fall backward.

So I am going to call panel one forward. That includes the Honorable Eleanor Hill, the Inspector General of the Department of Defense. She is accompanied by Robert J. Lieberman, the Assistant Inspector General for Audit. Mr. Gene Dodaro, Assistant Comptroller General of the management area in the U.S. General Accounting Office. He will be accompanied by Ms. Lisa Jacobson, Director of Defense Audits, Accounting and Information Management Division of GAO. And Mr. David Warren, Director of Defense Management, National Security and International Affairs Division of GAO.

So if that group will come forward. Mr. Warren, you will be here, Ms. Jacobson, Mr. Dodaro, and Ms. Hill. I think you know the routine here.

[Witnesses affirmed.]

Mr. HORN. The clerk will note that all five witnesses affirmed the oath.

We'll begin with the distinguished Inspector General of the Department of Defense, Ms. Hill.

STATEMENTS OF ELEANOR HILL, INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, ACCOMPANIED BY ROBERT J. LIEBERMAN, ASSISTANT INSPECTOR GENERAL FOR AUDIT; GENE L. DODARO, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LISA G. JACOBSON, DIRECTOR OF DEFENSE AUDITS, ACCOUNTING AND INFORMATION AND MANAGEMENT DIVISION; AND DAVID WARREN, DIRECTOR OF DEFENSE MANAGEMENT, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

Ms. HILL. Thank you, Mr. Chairman. I want to thank you for the opportunity to discuss with you today financial management in the Department of Defense. I have a full written statement for the record, which I'd like to summarize.

Mr. HORN. Those are automatically put in the Record the minute we introduce you.

Ms. HILL. Thank you.

In the past, most DOD business processes were decentralized, controlled in theory by elaborately detailed rules and regulations developed unilaterally by organizations operating within their own functional stovepipe with insufficient coordination with other stakeholders and often labor intensive despite the use of many thousands of automated systems. Each military department operated dozens of finance and accounting systems. Data element standardization was never effectively enforced. DOD accounting policies were enunciated in a handbook whose precepts were not mandatory and, therefore, were widely ignored. The primary focus of financial reporting was on funds control, not on providing the full range of financial data needed by managers.

With the end of the cold war and the imposition of severe DOD budget constraints, the Department and the Congress recognized the need to reform the entire range of Defense business practices. For nearly 10 years, the Department has been engaged in reinventing all of these processes simultaneously. While indeed much has been accomplished, much remains to be done in all aspects of the Department's operations.

My office has issued 181 audit reports on finance and accounting matters since I last testified before this subcommittee in 1995, and only a handful of those reports have been good news. The Military Department audit agencies have also done a substantial part of the CFO audit work and produced numerous reports. Although tens of billions of dollars' worth of auditor-recommended adjustments are being made annually to financial statements and hundreds of other audit recommendations are being accepted, I cannot yet report to you that the Department has successfully corrected the many shortcomings in its accounting and financial statements.

The financial statement data for most DOD funds remains unreliable and essentially not in condition for audit. In accounting terms, the situation still can best be described as a general lack of effective internal management controls. Consequently, we and the Service audit organizations were unable to give audit opinions on the financial statements for either the DOD-wide consolidated statements or all but one of the major fund statements for fiscal year 1997.

The primary reason for these disclaimers of opinion is the fact that the accounting systems supporting DOD general funds cannot compile and report accurate and reliable information. Accounting systems supporting DOD general funds continue to lack integrated, double-entry, transaction-driven general ledgers to compile and report reliable and auditable information. The information is not auditable because the accounting systems cannot produce an audit trail of information from occurrence of a transaction through its recognition in accounting records and ultimately to the general fund financial statements.

As in previous years, DOD made huge numbers of adjustments, many of which were unsupported. For example, the DFAS Indianapolis Center made $350 billion of unsupported adjustments to make the fiscal year 1997 Army General Fund general ledger accounts match the corresponding status of appropriations data.

Because of the accounting systems' inadequacies, auditors have not been able to obtain sufficient evidence or apply other auditing procedures to satisfy themselves as to the fairness and the accuracy of the data reported on DOD general fund financial statements. This is a significant long-standing scope limitation that will likely continue to cause auditors to disclaim opinions on the DOD general fund financial statements. The Department does not expect to see most of the necessary accounting systems fully in operation before 2003.

Since 1995 there have been various other developments affecting the general funds, and my statement lists several of those. I just want to mention a few.

The Defense Property Accountability System, called DPAS, which was proposed as the answer to unreliable reporting of real and personal property, is being fielded but has fallen far short of expectations.

The General Accounting Office and DOD auditors performed a coordinated review of the reporting of DOD mission assets during the fiscal year 1997 CFO audit. Based on a sampling methodology designed to result in a pass/fail conclusion on the categories of the items sampled, the Army and Air Force passed, while the Navy failed in 3 of the 11 categories.

The Army Corps of Engineers attempted to produce auditable Southwest Division financial statements because the Corps had completed development and implementation of its new accounting system, the Corps of Engineers Financial Management System, referred to as CEFMS, within that division. This effort did prove successful, as the auditors gave an unqualified opinion on the fiscal year 1997 Southwest Division financial statement.

That same accounting system, CEFMS, serves as the basis for what is known as the Defense Joint Accounting System. Recently, however, the plan for DOD-wide use of the Defense Joint Accounting System has undergone major revision and it is now unclear how many DOD organizations will ever use the common system.

Two years ago, we participated in a joint DOD effort to deal with the long-standing problems related to control of government-owned property in the possession of contractors. One of the reasons for disclaimers of opinion on various financial statements is the lack of any reliable data on the depreciated value of an estimated $90 billion of property in the hands of contractors. It was agreed that the appropriate accounting treatment for this property would be identified and the necessary instructions would be provided to the owning activities or DOD property administrators. Unfortunately, no progress has been made.

Let me also briefly turn to some of the issues pertaining to the Defense Working Capital Funds.

In December 1996, the Under Secretary of Defense, Comptroller, announced that the Defense business operations fund would be broken up and replaced with several working capital funds. Unfortunately, this restructuring did not eliminate the financial reporting deficiencies that caused disclaimers of audit opinions on Defense Business Operations Fund financial statements for fiscal year 1992 through fiscal year 1996.

For example, adjustments made to the Air Force, Transportation Command and Joint Logistic Systems Center working capital funds by the DFAS Denver Center were not adequately supported. In fiscal year 1996, the Denver Center made 124 adjustments for $227 billion, of which 111 adjustments for $217 billion were not supported. If DFAS had adequate accounting systems, many of these adjustments would be unnecessary.

The Department has developed a long-term plan to reduce the number of accounting systems from 82 to 15 that support the working capital funds and to correct the deficiencies in the systems selected for retention. Although some progress has been made in eliminating systems, few working capital fund accounting systems have implemented the U.S. standard general ledger; and no systems are fully compliant with Federal financial management system requirements and Federal accounting standards.

Significant control weaknesses continue to affect the accurate reporting of inventory accounts in several working capital fund business areas. These weaknesses will affect the fair presentation of both the individual working capital fund and DOD-wide financial statements and prevent favorable audit opinions. We believe the most serious problems in accounting systems will remain unresolved for some time.

Most of the operations financed by these working capital funds fall under the purview of the supply, maintenance, transportation, communications, and information processing communities within the Department; and much of the data feeding the financial systems comes from nonfinancial systems. We believe that the commitment of DOD managers to the goal of compliance with the CFO Act is, especially outside the finance and accounting community, very tenuous.

Signals, such as the previously mentioned inability to get all major DOD organizations to use the supposedly joint Defense Property Accountability System, are disquieting. We believe that closer Office of the Secretary of Defense level oversight of these systems development efforts is crucial.

We have been disappointed that the DOD Senior Financial Management Oversight Council, which was described as the capstone of the DOD financial management reform organizational structure, has not met in over a year and has not discussed compliance with the CFO Act in 4 years. Although CFO Act issues are frequently discussed among leaders of the DOD finance and accounting organizations, the leaders of many non-finance functional areas need to be more actively engaged.

Another frustration that is widely evident in the Department of Defense concerns the excessive complexity of DOD accounting. It is ironic that there is strong support for streamlining organizations, regulations and processes, yet there is dogged resistance to the concept of simplifying our accounting.

The Department is moving forward in reducing the number of finance and accounting systems, which stood at 324 in 1991 and is down to 122 now. The goal is 23 by fiscal year 2003. Whether we have hundreds of systems or just a few, however, there will still be tremendous complexity, work load, and vulnerability to errors unless we also reengineer the accounting structure.

The Department's accounting methods were designed decades ago to maintain the integrity of each of the tens of thousands of accounts maintained by the Department of Defense in what is undoubtedly the most complicated chart of accounts in the world. This multiplicity of "colors of money" is a root cause of the formidable DOD problems with the accuracy of accounting data, the complexity of our contracts, the difficulty of properly managing disbursements and progress payments, the high overhead costs of DOD budget and accounting operations, and the considerable restrictions on the flexibility of managers to shift funds quickly to meet contingencies. Millions of documents must contain at least one, and in some cases many, accounting classification codes that typically have from 46 to 55 characters each.

Compare 16 characters used for a typical commercial credit card to the 46 characters in the example that we have cited in our statement, which is a typical Navy fund citation. And, I might add, I am told that that cite which we give you in the statement, which is 46 characters, would actually be further enhanced by an additional contract number, so it would come out to something like 61 characters.

We believe that the DOD and the Congress ought to reconsider the need for so many discrete appropriations and subcommittees. Many of these kinds of issues are seldom considered in the context of management reform, but we believe that any streamlining of DOD financial management requirements would considerably assist managers in cutting overhead costs throughout the Department.

During my previous testimony, I recounted that as long as 213 years ago the Congress and the military establishment had been debating the need for adequate audit trails for military expenditures. Unfortunately, we are now going on 217 years; and the Department still cannot provide you an acceptable accounting of expenditures.

In closing, I just want to assure the chairman that the DOD audit community is, in fact, very much aware of the explicit mandates on this subject and we will continue to do all that we can to move the Department forward to full compliance with the CFO Act.

Thank you, Mr. Chairman.

Mr. HORN. We thank you.

[The prepared statement of Ms. Hill follows:]

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to discuss with you today financial management in the Department of Defense, with emphasis on the Department's continued efforts to achieve compliance with the Chief Financial Officers Act and related statutes. As you know, I testified before this committee on November 14, 1995, and at that time outlined the significant impediments hampering the preparation of auditable annual financial statements by the Department. There has been little controversy about what those impediments are. The Department has generally agreed with the huge number of audit findings on the subject. Its management representation letters, annual management control assurance statements, and other reports to the Office of Management and Budget and the Congress have acknowledged the scope of the problem.

The Department's accounting systems and financial reporting practices mirrored its overall management philosophy during the 1950's through 1980's. Most DoD business processes--acquisition, inventory management, maintenance, training, and many others--were decentralized; controlled in theory by elaborately detailed rules and regulations; developed unilaterally by organizations operating within their own functional "stovepipe" with insufficient coordination with other stakeholders; and often labor intensive despite the use of many thousands of automated systems. In the finance and accounting area, each Military Department operated dozens of systems; data element standardization was never effectively enforced; DoD accounting policies were enunciated in a Handbook whose precepts were not mandatory and therefore were widely ignored; and the primary focus of financial reporting was on funds control, not on providing the full range of financial data needed by managers. In retrospect, it is remarkable how infrequently the DoD accounting community was asked questions along the lines of how much does it cost to run a base, fill a requisition or operate a warehouse.

With the end of the Cold War and the imposition of severe DoD budget constraints, the Department and the Congress recognized the need to reform the entire range of DoD business practices. For nearly ten years, the Department has been engaged in reinventing all of those processes simultaneously. While indeed much has been accomplished, much remains to be done in all aspects of the Department's operations. Last month I testified, for example, before a Senate committee that was evaluating the impact of acquisition reform, about problems in pricing for spare parts, and opportunities for further acquisition process improvements.

Nearly all of my office's audit and evaluation work directly relates to the Department's high risk areas and strategic management reform goals. Therefore we have an overview of the relative progress being made in reengineering each DoD functional area. Although each of those areas entails tremendous complexity and many challenges, it is easier to enumerate or quantify progress in most other areas than in finance and accounting. This is frustrating to everyone--the Congress, OMB, DoD managers, the comptrollers, and the auditors.

My office has issued 181 audit reports on finance and accounting matters since I last testified before you, and only a handful have been good news. Some examples of our recent reports are summarized at Attachment 1. The Military Department audit agencies have also done a substantial part of the CFO audit work and produced numerous reports. Although tens of billions of dollars' worth of auditor-recommended adjustments are being made annually to financial statements and hundreds of other audit recommendations are being accepted, I cannot yet report to you that the Department has successfully corrected the many shortcomings in its accounting and financial systems.

The financial statement data for most DoD funds remain unreliable and essentially not in condition for audit. In accounting terms, the situation still can best be described as a general lack of effective internal management controls. Consequently, we and the Service audit organizations were unable to give audit opinions on the financial statements for either the DoD-wide consolidated statements or all but one of the major fund statements for FY 1997. We are still working on the Military Retirement Trust Fund statements, which probably will merit an unqualified (clean) opinion and be the only exception to the list of disclaimers. A complete listing of the audit opinions is at Attachment 2 to this statement.

GENERAL FUNDS

The primary reason for disclaimers of opinion on all DoD general fund financial statements for FY 1997 has not changed since the November 15, 1995, testimony; the accounting systems supporting DoD general funds cannot compile and report accurate and reliable information. Accounting systems supporting DoD general funds continue to lack integrated, double-entry, transaction-driven general ledgers to compile and report reliable and auditable information. The information is not auditable because the accounting systems cannot produce an audit trail of information from occurrence of a transaction through its recognition in accounting records and ultimately to the general fund financial statements. Not all information from the audits of the FY 1997 financial statements is available yet, but it is apparent that, as in previous years, DoD made huge numbers of adjustments, many of which were unsupported. For example, the DFAS Indianapolis Center made $350 billion of unsupported adjustments to make the FY 1997 Army General Fund general ledger accounts match the corresponding status of appropriations data.

Because of the accounting systems' inadequacies, auditors have not been able to obtain sufficient evidence or apply other auditing procedures to satisfy themselves as to the fairness and accuracy of the data reported on DoD general fund financial statements. Until accounting systems with integrated, double-entry, transaction-driven general ledgers are developed to compile and report information, auditors will remain largely unable to determine whether valid transactions are properly recorded, processed, and summarized. This is a significant long-standing scope limitation that will likely continue to cause auditors to disclaim opinions on the DoD general fund financial statements. The Department does not expect to see most of the necessary systems fully in operation before 2003.

Since 1995 there have been various other developments affecting the general funds. Some are positive and others present mixed signals.

- The Defense Property Accountability System (DPAS), which was proposed as the answer to unreliable reporting of real and personal property, is being fielded, but has fallen short of expectations. Specifically, DPAS only captures about a quarter ($182 billion out of $773 billion reported in FY 1996) of real and personal property and does not completely address the systemic weaknesses it was intended to correct.

- The General Accounting Office and DoD auditors performed a coordinated review of DoD mission assets during the FY 1997 CFO audit. Mission assets, more properly referred to as National Defense Property, Plant and Equipment, are weapon systems and other equipment used in the performance of actual military operations. Examples would be aircraft, ships, trucks and jet engines. The purpose of the joint effort was to test mission assets for completeness of reporting and existence of assets. Based on a sampling methodology designed to result in a pass/fail conclusion on the categories of the items sampled, the Army and Air Force passed, while the Navy failed in three of the eleven categories.

- In FY 1997, the Army Corps of Engineers, with support from the Army Audit Agency, attempted to produce auditable Southwest Division financial statements because the Corps had completed development and implementation of its new accounting system, the Corps of Engineers Financial Management System (CEFMS), within that Division. This effort proved successful, as the auditors gave an unqualified opinion on the FY 1997 Southwest Division financial statements. The Army is completing deployment of CEFMS throughout the remainder of the Corps and is anticipating a possible favorable opinion on the FY 1999 financial statements for the Corps of Engineers, Civil Works Program.

- With extensive modifications, CEFMS serves as the basis for the Defense Joint Accounting System (DJAS). Recently the plan for DoD-wide use of DJAS has undergone major revision, however, and it is now unclear how many DoD organizations will ever use the common system.

- The Air Force, with support from the Air Force Audit Agency, attempted to produce an auditable Statement of Budgetary Resources for FY 1997. Although work continues on the statement and many challenges remain, the lessons learned from this commendable effort will provide a baseline for a potentially favorable audit opinion on the FY 1998 Air Force Statement of Budgetary Resources and for the other Services to apply in attempting to produce auditable FY 1998 Statements of Budgetary resources.

- Two years ago, we participated in a joint effort led by the Under Secretary of Defense (Comptroller) and Principal Deputy Under Secretary of Defense (Acquisition and Technology) to deal with the long-standing problems related to control of Government-owned property in the possession of contractors. Those problems fall under two categories, accounting for the property and reengineering the related business practices--acquisition, inventory control, reutilization and disposal. In brief, one of the reasons for disclaimers of opinion on various general fund and working capital fund financial statements is the lack of any reliable data on the depreciated value of an estimated $90 billion (acquisition value) of military property, material, tools and equipment, as well as real property in the hands of contractors. It was agreed that the appropriate accounting treatment for this property would be identified and the necessary instructions provided to the owning activities or DoD property administrators. Unfortunately, no progress has been made. Similarly, the acquisition community initiated procurement rule changes to change the practice of the Government automatically taking title to property, whether or not there was any reasonable chance of reutilization, but that effort has also bogged down.

- One of the benefits of financial statements is disclosure of liabilities. Such information should have practical applications for DoD program/budget planning. Initially, there were great concerns over criteria and methodology for estimating and reporting liabilities. Progress is being made, although this remains a difficult area. For example, the DoD-wide statements need to reflect liabilities related to military retirement health benefits. The estimate in FY 1997 was for $218 billion, which is a 100-year projection. This projection is questionable because it was based on an inadequate sample (data from only 15 of 121 DoD treatment facilities) and the 1992-1994 data used for the projection were not updated, and used unaudited budget information.

- Another example concerns environmental costs. The reporting of estimated environmental cleanup liability is becoming more accurate, increasing from $17.9 billion for FY 1996 to $38.3 billion for FY 1997. Liabilities for disposal of hazardous waste and remediation of environmental contamination for FY 1997 remained materially understated, as a whole, primarily because an estimate for the associated liability had not been developed for major weapon systems such as aircraft, missiles, ships and submarines, as well as ammunition. DoD had not implemented the accounting standards that require recognizing and reporting environmental costs associated with weapon systems, nor had DoD provided guidance to the Services. This is an example of where the DoD management reform goals in other areas ought to dovetail with the effort to produce accurate financial statements, but the linkage is not evident to most DoD managers. In this case, DoD managers are supposed to be putting heavy emphasis on identifying and reducing the life cycle cost of weapon systems and the cost of logistics operations, including disposal. Estimating environmental cleanup liabilities should be an integral part of life cycle cost estimating. There is a very practical imperative at work here, not just an arcane accounting requirement.

DEFENSE BUSINESS OPERATIONS FUND/WORKING CAPITAL FUNDS

One of the most touted DoD management initiatives of the 1990's was consolidating all industrial funds and stock funds into the Defense Business Operations Fund, which became the primary vehicle for financing DoD support activities such as supply, maintenance, transportation, finance, and information processing. This experiment in centralized cash management proved unsuccessful. In December 1996, the Under Secretary of Defense (Comptroller) announced that the Fund would be broken up and replaced with several Working Capital Funds. The 13 business areas under the Defense Business Operations Fund were restructured under the Military Services and the Defense agencies. This restructuring did not affect the financial reporting deficiencies that caused disclaimers of audit opinions on Defense Business Operations Fund financial statements for FY 1992 through FY 1996. Those problems include accounting system deficiencies, poor audit trails, unsupported and unverified transactions, and difficulty in determining property ownership.

For example, adjustments made to the Air Force, Transportation Command, and Joint Logistics Systems Center working capital funds by the DFAS Denver Center were not adequately supported. In FY 1996, the Denver Center made 124 adjustments for $227 billion, of which 111 adjustments for $217 billion were not supported. The last nine adjustments made for FY 1996, which were not supported, changed the Air Force results of operations from a loss of

$11 billion to a gain of $2.2 billion. For FY 1997, the Denver Center made 129 adjustments for $161 billion. We have not completed our review of the FY 1997 adjustments and cannot state at this time the number of adjustments that were adequately supported. We have noticed an improvement in the amount of documentation provided, but we are concerned with the number and types of adjustments that are made because of deficiencies in the accounting systems used. If DFAS had adequate accounting systems, many of the adjustments would be unnecessary.

The Department has developed a long-term plan to reduce the number of accounting systems from 82 to 15 that support the working capital funds and to correct the deficiencies in the systems selected for retention. Although some progress has been made in eliminating systems, few working capital fund accounting systems have implemented the U.S. standard general ledger, and no systems are fully compliant with Federal financial management system requirements and Federal accounting standards. Significant control weaknesses continue to affect the accurate reporting of inventory accounts in several working capital fund business areas. Since inventory is the primary asset reported on the working capital fund financial statements, these weaknesses will affect the fair presentation of both the individual working capital fund and DoD-wide financial statements and prevent favorable audit opinions. We believe the most serious problems in accounting systems will remain unresolved for some time.

Financial reporting for the working capital funds should be geared to management's needs. Most of the operations financed by these funds fall under the purview of the supply, maintenance, transportation, communications and information processing communities and much of the data feeding the financial systems come from non-financial systems, especially logistics systems. This makes close cooperation among the "owners" of the financial systems and the feeder systems absolutely vital in terms of improving DoD financial reporting and designing more useful, reliable and capable systems for the future. While there is repeated acknowledgment of the need for such cooperation, we believe that the commitment of DoD managers to the goal of CFO Act compliance is, especially outside the finance and accounting community, very tenuous. Signals such as the previously mentioned inability to get all major DoD organizations to use the supposedly joint Defense Property Accountability System are disquieting. The recent consolidation of accounting system development efforts into a single Defense Financial and Accounting Service project office was a prudent decision, although we believe that closer Office of the Secretary of Defense level oversight of these systems development efforts is crucial.

We have been disappointed that the DoD Senior Financial Management Oversight Council, which was described as the capstone of the DoD financial management reform organizational structure in the Chief Financial Officer's Five Year Plan, has not met in over a year and has not discussed compliance with the CFO Act in four years. Although CFO Act issues are frequently discussed among leaders of the DoD finance and accounting organizations, the leaders of many non-finance functional areas do not appear to be actively engaged. This is not completely unexpected, in light of the sheer number of management challenges facing the Department and the resultant conflicting priorities.

AUDITING FINANCE AND ACCOUNTING OPERATIONS

Although there is widespread skepticism in the DoD concerning the value of financial statements themselves, the certainty of the annual financial audit has contributed to increased attention to problems that may not in all cases be material to DoD financial statements, but are important in achieving sound financial management. Such problems include disbursements that cannot be matched to original obligations, untimely purging of invalid obligations, overpayments to contractors, lack of attention to maintaining appropriation integrity when making progress payments, the Year 2000 computing problem, and vulnerability to computer tampering and fraud.

Unfortunately, financial statement audits are not necessarily the most efficient audit approach to identifying the scope and causes of such problems. For truly effective oversight, the financial statement audits required under the CFO Act need to be augmented with a robust annual program of operational audits of finance operations. Due to the combination of the downsizing of my office (58 percent of non-CFO audit teams must be eliminated by 2002 under current plans), the high demand for audit support in other DoD high risk areas, and the highly labor intensive nature of financial statement audits for huge funds with many assets, our overall coverage in the finance and accounting area is bordering on inadequate. For example, the Defense Commissary Agency is the tenth largest food retailer in the United States in sales. We audited the FY 1997 Financial Statements with a team of four auditors, which was feasible only because the underlying systems and controls were in such a state that no more than limited audit tests were considered necessary.

We have earmarked 20 audit teams to CFO Act work, which is a major commitment in light of all other priorities. By 2002, those 20 teams will be a full one-third of our entire audit staff. Although the DoD audit community is proud of its strong commitment to meeting the CFO audit challenge, we feel that we are losing ground in terms of having the resources to get the job done. Over the past several years, our audit reports on such matters as the "M" accounts, problem disbursements, and DoD compliance with budget authorization and appropriation act mandates have been widely used by DoD managers and Congress. By FY 1998, we are already unable to offer as much insight into such matters as we did previously, and this trend will become even more marked if our downsizing continues.

It is perhaps not well understood that CFO Act audit requirements are increasing for a variety of reasons:

- First, the Government Management Reform Act expanded the mandatory audit requirements to cover all DoD funds.

- Second, guidance from the Federal Accounting Standards Advisory Board and OMB increased the number of statements to be provided for each fund from 3 to 8. This will create various new reconciliation challenges for both the preparers and auditors of these statements.

- Third, under current plans, the number of DoD reporting entities (funds for which financial statements, management representation letters, and legal representation letters are prepared) has grown from 11 in 1995 to 20 in 1998. We have recently advised the Under Secretary of Defense (Comptroller) that it is impossible to execute a plan for separate audit opinions for so many reporting entities, given our resource constraints. In addition, we need to put top audit priority on focusing on those major areas that most materially affect the DoD-wide consolidated statements and the Government-wide statements. We have proposed a more practical approach involving separate audit opinions for 13 reporting entities.

- Fourth, concerns regarding the security of automated financial systems have become much more prominent as the DoD has identified the broad overall threat posed to all of its systems by computer hackers. According to estimates from the Defense Information Systems Agency, DoD systems are attacked approximately 250,000 times per year.

- Fifth, the ability of both the finance and accounting automated systems and the other systems with which they exchange data to compute accurately after January 1, 2000, is a serious concern. Across the board, the DoD audit community now has about 150 auditors working on the "Y2K" problem, and this commitment is likely to grow.

- As DoD funds reach the point where clean audit opinions are within reach, the scope and intensity of transaction testing by the auditors may increase. At the present time, audit scope is limited in many cases because of the state of the records.

NEED TO SIMPLIFY ACCOUNTING

Another frustration that is widely evident in the DoD at the present time concerns the excessive complexity of DoD accounting.

It is ironic that there is strong support for streamlining organizations, regulations and processes, yet there is dogged resistance to the concept of simplifying our accounting.

The Department is moving forward in reducing the number of accounting systems, which stood at 324 in 1991 and is down to 122 now. The goal is 23 by FY 2003. Whether we have hundreds of systems or just a few, however, there will still be tremendous complexity, workload, and vulnerability to errors unless we also reengineer the accounting structure itself.

The Department's accounting methods were designed decades ago to maintain the integrity of each of the tens of thousands of accounts maintained by the DoD in what is undoubtedly the most complicated chart of accounts in the world. This multiplicity of "colors of money" is a root cause of the formidable DoD problems with the accuracy of accounting data, the complexity of our contracts, the difficulty of properly managing disbursements and progress payments, the high overhead costs of DoD budget and accounting operations, and the considerable restrictions on the flexibility of managers to shift funds quickly to meet contingencies. Millions of documents must contain at least one, and in some cases, many accounting classification codes that typically have from 46 to 55 characters each. Compare 16 characters used for a commercial credit card to a typical Navy fund cite:

17x1611 1936 026 54002 3 068572 ID 000151 000560852000

We believe that the DoD and Congress ought to reconsider the need for so many discrete appropriations and subaccounts. These kinds of issues are seldom considered in the context of management reform, but we believe that any streamlining of DoD financial management requirements would considerably assist managers in cutting overhead costs throughout the Department.

SUMMARY

During my previous testimony, I recounted that as long as 213 years ago, the Congress and the military establishment had been debating the need for adequate audit trails for military expenditures. Unfortunately, we are now going on 217 years and the Department still cannot provide you an acceptable accounting of expenditures. The DoD audit community is very much aware of the explicit mandates on this subject and we will continue to do all we can to move the Department forward to full compliance with the CFO Act.

EXAMPLES OF FY 1998 OFFICE OF INSPECTOR GENERAL, DOD, REPORTS ON FINANCE AND ACCOUNTING

Report No. 98-075, Distribution Depot Revenues, February 13, 1998. The Distribution Depot business area was not reimbursed for all transportation and container consolidation point services. Customers were only billed $126 million of the $275 million of costs incurred. As a result, the Distribution Depot business area lost approximately $150 million in FY 1996, and the lack of full reimbursement was not disclosed in the FY 1996 financial statements. Also, the Distribution Depot business area continued to provide services to customers in advance of, or in excess of the amount of, funded orders. Cumulative unfunded services ranged from $1 million to $75.4 million per month during the 15-month period ended December 31, 1996. As a result, the Distribution Depot business area experienced cumulative cash disbursements that exceeded cumulative cash collections by as much as $181.4 million during FY 1996. Cash shortages had to be covered by other Defense Business Operations Fund (DBOF) sources. These kinds of problems cause pricing distortions and complicate budget planning.

Report No. 98-072, Defense Business Operations Fund Inventory Record Accuracy, February 12, 1998. The audit assessed the accuracy of the perpetual inventory records for on-hand inventory maintained by the DoD inventory control points and retail storage activities. The audit was limited because DoD management had not developed and executed a DBOF-wide sample; we developed a sample to test inventory record accuracy.

The inventory records were not accurate. An estimated 15.8 percent, or about one of every six inventory records represented by our sampling, were wrong. The errors caused individual inventory records to be misstated (overstated and understated) by an estimated $3.9 billion. The net misstatement resulting from those errors was an estimated $336.3 million understatement of the $89 billion of on-hand inventory reflected in the FY 1996 financial statements. The inaccurate records greatly limited the reliability of the financial data. Inaccurate inventory records also distorted the reports used by inventory managers who made decisions to buy materiel. Additionally, inaccurate records can reduce the effectiveness of logistics support when military customers urgently need inventory.

The DoD inventory control points and retail storage activities did not implement a plan to conduct an annual statistical sample of the FY 1996 Defense Business Operations Fund inventory, as required by DoD policy.

Report No. 98-060, Joint Logistics Systems Center Reporting of System Development Costs, February 3, 1998. The Center did not transfer about $1.54 billion of systems development costs, incurred through the end of FY 1996, to the depot maintenance and supply management organizations responsible for capitalizing and reporting these costs on the financial statements. Additionally, the $1.54 billion and another $460 million in development costs to be incurred through FY 1998 will be improperly charged, through the recovery of depreciation costs, to customers of the depot maintenance and supply management business areas of the DoD Working Capital Funds. As a result, the Center's FY 1996 financial statements were materially overstated, and unless the systems development costs are properly transferred to the appropriate organizations, the financial statements for FY 1997 and beyond will continue to be overstated. Conversely, the financial statements of the organizations that receive the capital assets (that is, systems developments) will be understated. Also, unless the depreciation costs of the Center's systems developments are recorded as unfunded costs, customers of the DoD Working Capital Fund organizations that received the systems developments will have to pay again for nearly $2 billion in development costs.

Report No. 98-057, Defense Finance and Accounting Service Acquisition Program for the Electronic Document Management Program, January 27, 1998. The Defense Finance and Accounting Service (DFAS) Electronic Document Management Program will standardize document distribution, tracking, and storage. The Program is expected to improve processing time, reporting accuracy and customer service, resulting in reduced personnel costs. This audit report is one of a series on the DoD acquisition strategy for the DFAS Electronic Document Management Program and provides the results of our review of the Increment 1, Vendor Pay, life-cycle documentation. The Director, DFAS, requested that we review the implementation of the Program through the integrated product team process and provide input during the acquisition process.

The audit indicated that the integrated product team appropriately identified cost, funding, and testing concerns that needed to be resolved before a deployment decision could be recommended. The Program Office provided a cost reconciliation document, funding information, and a schedule for testing to minimize the concerns of the integrated product teams. Management incorporated several auditor suggestions into the program plan. DFAS developed the required life-cycle documentation and subsequently received a Milestone III deployment decision, for Increment 1, Vendor Pay, on December 16, 1997.

Report No. 98-050, Defense Business Operations Fund Adjustments at the Defense Finance and Accounting Service, Denver Center, January 20, 1998. The DFAS Denver Center did not have adequate supporting documentation, in accordance with DoD 7000.14-R DoD Financial Management Regulation, for 111 adjustments totaling $217.5 billion made to the Air Force, U.S. Transportation Command, and Joint Logistics Systems Center FY 1996 DBOF account balances. The last nine adjustments made without supporting documentation brought the Air Force DBOF Results of Operations from a loss of $11 billion to a gain of $2.2 billion, and the lack of audit trails contributed to the disclaimed audit opinion for the FY 1996 DBOF financial statements. In many instances, adjustments were made to the same accounts because the adjustments were recorded incorrectly, reversed, reestablished, decreased, or increased. However, we could not determine the validity of the adjustments because of the lack of supporting documentation.

Report 98-031, The DoD Contract Fund Reconciliation Process, December 5, 1997. Contract fund reconciliation is the process of matching obligation and disbursement data in contracting, disbursing, and accounting and finance systems to the specifications in the contract document. All DoD contracts eventually require contract fund reconciliation. Many contracts require reconciliation only at contract close-out. However, the large and complicated contracts for major weapon systems are frequently out of balance during their life cycle and require immediate reconciliation. During FY 1996, the DFAS Columbus Center and the Military Departments identified 9,652 contracts that were out of balance by a total of more than $1 billion. The audit found inefficient processes that were unnecessarily costly, time consuming, and ineffective in terms of facilitating accurate reporting, prompt payment and timely contract close-out.

Specifically, the Military Departments and DFAS did not routinely distribute the results of contract reconciliations, so much of the work was wasted. The inability to keep contracts in balance contributed to the Military Departments' need to obligate current-year funds to cover unmatched disbursements and negative unliquidated obligations that were more than 180 days old.

The DoD organizations did not use standardized methods to perform contract reconciliation. Also, automated reconciliation systems in use and under development lacked a standardized output. As a result, contract fund reconciliations were not readily accepted or exchanged by the various DoD Components that performed them, resulting in duplication of reconciliation efforts. In FY 1996, 278 contracts were reconciled concurrently. Last, DFAS Columbus Center did not ensure that Defense agencies with Army Fiscal Station numbers received copies of internal adjustments. As a result, contracts at those Defense agencies required extensive reconciliations.

Report No. 98-002, A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996, October 3, 1997. The FY 1996 Defense Business Operations Fund financial statements identified assets of $92.2 billion, liabilities of $18.4 billion, and revenues of $73.7 billion.

We identified significant accounting and management control deficiencies in the Defense Business Operations Fund that prevented the timely development and reliable presentation of the financial statements. The deficiencies were:

- Interim Migratory Accounting Strategy;
- cash management;
- standard general ledger;
- documentation and audit trails;
- property, plant, and equipment;
- valuation and reporting of inventory; and
- personnel.

The problems that were identified affected approximately 67.8 percent of total assets and 16.6 percent of total revenues. The deficiencies resulted in auditor recommended adjustments of $75.1 billion to the FY 1996 financial statements and the supporting accounting records. Many of the deficiencies noted in last year's report remain uncorrected, as candidly acknowledged by the Under Secretary of Defense (Comptroller) in his Management Representation Letter.

FY 1997 CFO Audit Opinions

Report Title	Audit Organization	Opinion
Disclaimer of Opinion on the Department of Defense Consolidated Financial Statements for FY 1997	OIG, DoD	Disclaimer
Army's Principal Financial Statements for Fiscal Years 1997 and 1996	Army Audit Agency	Disclaimer
Army Working Capital Fund Principal Financial Statements for FY 1997	Army Audit Agency	Disclaimer
FY 97 Financial Statements Opinion Report U.S. Army Corps of Engineers, Civil Works[1]	Army Audit Agency	Disclaimer
Department of the Navy Principal Statements for Fiscal Years 1997 and 1996: Report on Auditor's Opinion	Naval Audit Service	Disclaimer
Independent Auditor's Opinion on the Statement of Financial Position of the FY 1997 Department of the Navy Working Capital Fund Consolidated Financial Statements	Naval Audit Service	Disclaimer
Report of Audit, Opinion on Fiscal Year 1997 Air Force Consolidated Financial Statements	Air Force Audit Agency	Disclaimer
Report of Audit, Opinion on Fiscal Year 1997 Air Force Working Capital Fund Financial Statements	Air Force Audit Agency	Disclaimer
Audit Opinion on the Defense Logistics Agency Working Capital Fund Financial Statements for FY 1997	OIG, DoD	Disclaimer
Disclaimer of Opinion on the Defense Information Systems Agency Defense-Wide Working Capital Fund Financial Statements for FY 1997	OIG, DoD	Disclaimer
Disclaimer of Opinion on the Defense Finance and Accounting Service Working Capital Fund Financial Statements for FY 1997	OIG, DoD	Disclaimer

[1] Southwest Division statements received an unqualified opinion.

Disclaimer of Opinion on the Defense Commissary Agency Financial Statements for FY 1997	OIG, DoD	Disclaimer
Audit Opinion on the Military Retirement Trust Fund Financial Statements for FYs 1997 and 1996	OIG, DoD	In Process
Disclaimer of Opinion on the National Defense Stockpile Transaction Fund Financial Statements for FY 1997	OIG, DoD	Disclaimer
Disclaimer of Opinion on the Defense Security Assistance Agency Financial Statements for FY 1997	OIG, DoD	Disclaimer
Disclaimer of Opinion on the Joint Logistics Systems Center Working Capital Fund Financial Statements for FY 1997	OIG, DoD	Disclaimer

Mr. HORN. We have the distinguished Assistant Comptroller General, Mr. Dodaro, who will finally take a day off this week—tomorrow, not today.

Mr. DODARO. Good morning, Mr. Chairman, Congressman Kucinich. We are pleased to be here today to discuss financial management at the Department of Defense.

Ms. Hill has provided a very good enumeration of all the problems impeding rendering an opinion on the Department of Defense's financial statements, and my written statement details our views on many of the same topics. So, consequently, this morning I'd like to focus on four major points.

First, I'd like to underscore the important role that DOD plays in GAO's shaping opinion on the overall consolidated financial statements of the Federal Government. DOD's size and scope of operations has a tremendous impact on the consolidated reporting of the Federal Government's assets, liabilities, and costs of operations.

The problems that Ms. Hill and we have reported collectively represent the largest single obstacle to ever obtaining an unqualified opinion on the consolidated statements of the U.S. Government. Greater progress will have to be made if the executive branch is to achieve its goal of obtaining an unqualified opinion on the financial statements for fiscal year 1999.

My second point is that many of these problems are not just accounting problems. Basically, it's obvious the impact that they have, though, on the inability to establish proper accountability for the Department's expenditures. But many problems that have been identified also impair the Department's ability to operate in the most effective and efficient manner possible.

For example, lack of adequate visibility of the DOD's assets is a contributing factor in the billions of dollars in excess inventory that the Department purchases. This drains resources away from defense priorities on readiness and developing and modernizing their weapon systems.

Also, serious weaknesses in computer security can compromise military operations and also makes the information in unclassified financial and logistical systems particularly vulnerable to unauthorized access, intrusion, manipulation, and even destruction of some of the information. Also, the inability to accurately account for all liabilities has obvious repercussions on the government's ability to accurately estimate downstream costs when making resource decisions.

In addition, the inability to accurately develop cost-accounting information and reliable performance measures will basically undermine the ability of the Department to successfully and fully implement the Government Performance and Results Act as well.

So there's all sorts of other management reforms that rest upon having a good financial management foundation, and the Department doesn't have one. Consequently, it is going to be continued to be hampered in their ability to bring about the full range of management reforms.

My third point is that, basically, short-term progress in developing at least good year-end financial information has to be made.

I was here yesterday talking about the fact that the Internal Revenue Service has tremendous problems with its financial management systems, and they need to be modernized as well. But through designing special procedures and tests, statistical sampling techniques, we and the Internal Revenue Service have been able to get to a point where we can at least get good year-end information on their activities.

The Department of Energy, for example, has not only estimated their full range of environmental liabilities, but they have been able to obtain an unqualified opinion on their financial statements. So progress is possible, but in the short term we must find ways to make similar progress at the Department of Defense.

This is particularly true because of the year 2000 problem. Long-term systems development efforts at this point are going to have to take a back seat to fixing the existing financial management and other systems in the Department in order to make them year 2000 compliant. So DOD basically is going to have to operate largely as a government DOD with the existing structure at least until it can assure year 2000 compliance.

Now, some of the systems will be replaced but most are going to be repaired during this interim period. So it underscores the fact that DOD needs to focus on short-term solutions to these problems while awaiting long-term modernization efforts. And progress is possible, but it is going to take a lot of commitment, dedication and hard work on the parts of both the department managers across the Department as well as the assistance from the audit community.

My fourth, and final point is to reiterate Ms. Hill's views on the need for leadership. Nowhere across the Federal Government have we seen improvements that have been put in place for financial management without dedicated, sustained leadership on the part of top officials in the department. This is particularly important at the Department of Defense because many of the solutions to these problems transcend organizational and functional boundaries and call for leadership at the highest levels in the Department. This is possible, but DOD really needs focused, appropriate plans and established accountability.

In conclusion, I'd like to publicly thank Ms. Hill and her organization for cooperating with us in exercising our responsibilities to render an opinion on the governmentwide consolidated financial statements as well as cooperation we have received from the Department. And I'd like to reiterate our commitment to continue to work with the Department of Defense in solving these problems and bringing about full accountability and improvements that can enhance its ability to accomplish its mission.

Thank you, Mr. Chairman. We'd be pleased to answer any questions.

Mr. HORN. Well, we thank both of you.

[The prepared statement of Mr. Dodaro follows:]

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to participate in this important hearing to discuss the status of financial management at the Department of Defense (DOD). This discussion is timely in light of our recent report on the first-ever consolidated financial statements of the U.S. government subjected to audit.[1] The Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, also requires annual audited financial statements for DOD, along with other major individual departments and agencies across the executive branch. The goals of these acts are to promote greater accountability in managing government finances by improving financial systems, strengthening financial personnel qualifications, and generating more reliable, timely information on the costs and financial performance of government operations.

Material financial management deficiencies identified at DOD, taken together, represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements. DOD's vast operations encompass a reported over $1 trillion in assets, nearly $1 trillion in liabilities, 3 million military and civilian personnel, and outlays of $262 billion in fiscal year 1997, or about 48 percent of total discretionary spending for the entire government. Consequently, DOD's operations have a tremendous impact on the government's consolidated reporting.

No major part of DOD has been able to pass the test of an independent audit; auditors consistently have issued disclaimers of opinion because of pervasive weaknesses in DOD's financial management operations. Such problems led us in 1995 to put DOD financial management on our list of high-risk areas vulnerable to waste, fraud, abuse, and mismanagement.[2]

The audits of DOD's and individual military services' financial statements for fiscal year 1997 performed by the DOD Inspector General (IG) and the service audit agencies, as well as our audit of the U.S. government's financial statements, have provided further clarification of the scope and magnitude of the Department's problems, and recommendations to correct them. These problems range from an inability to properly account for billions of dollars in assets, to not properly estimating the full extent of the government's liabilities, to not being able to accurately report disbursements and account for basic transactions. Collectively, these problems leave DOD highly vulnerable to the loss of assets and inefficient operations.

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[1] Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

[2] High-Risk Series: An Overview (GAO/HR-95-1, February 1995) and High-Risk Series: Defense Financial Management (GAO/HR-97-3, February 1997).

Expenditures on wasteful or inefficient operations divert scarce resources from defense priorities such as weapon systems modernization and readiness. Financial management weaknesses also greatly impede DOD's ability to have reliable and timely information needed to make sound resource decisions. Moreover, such weaknesses prevent DOD from routinely generating the type of management information needed to effectively and efficiently manage its day-to-day operations.

DOD recognizes these problems and has many efforts underway or planned to address them. However, the Department is struggling to meet the many challenges brought about by decades of neglect and an inability to fully institute sound financial management practices. Achieving the financial management goals established by the CFO Act, particularly in light of the serious and widespread nature of DOD's long-standing financial management problems, will only be possible with the sustained, demonstrated commitment of the Department's top leaders.

I will focus my remarks today on the serious material weaknesses now confronting the Department, the resulting impact on DOD's ability to effectively carry out its programs and operations, and the efforts underway to address these deficiencies. These material deficiencies include DOD's inability to

- properly account for and report billions of dollars of property, equipment, inventory, and supplies;
- estimate and report material amounts of environmental and disposal liabilities and related costs;
- determine the liability associated with the future cost of post-retirement health benefits for military employees;
- accurately report the net costs of its operations;
- properly account for billions of dollars of basic transactions, especially those between DOD component organizations and between DOD and other federal government entities; and
- ensure that all disbursements are properly recorded and reconciled.

I will also discuss two key areas that affect the ultimate resolution of DOD's long-standing financial management deficiencies: financial management personnel training and financial systems improvement. Finally, my statement touches upon two serious governmentwide problems that are critical areas at DOD–preparations to handle the Year 2000 problem and actions needed to address computer security threats.

DEFICIENCIES RELATED TO PROPERTY, PLANT AND EQUIPMENT AND INVENTORIES

As discussed in our recent report on the fiscal year 1997 consolidated financial statements, the federal government–one of the world's largest holders of physical assets–does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than $1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records.

With an estimated $1 trillion in physical assets, DOD is by far the largest holder of physical assets in the federal government. DOD relies primarily on various logistical systems both to maintain accountability and visibility over its assets to meet its military objectives and readiness goals, as well as to report information on these assets in its financial statements. As part of the fiscal year 1997 financial statement audit work, auditors tested the reliability of the information in these systems. As discussed in the following sections, serious material weaknesses were found in DOD systems and processes relied on to maintain accountability and to control physical assets under its purview, including military equipment; general property, plant and equipment; and inventories. In addition, included in these physical assets is a reported $90 billion of government material in the hands of contractors. Accurately accounting for and controlling these contractor-held assets has been a long-standing issue in DOD. The DOD IG has issued numerous reports on this problem and is actively working with the agency to develop controls and processes to improve the accuracy of this information.

Overall, these problems impair DOD's ability to (1) know the location and condition of all its assets, including those used for deployment, (2) safeguard assets from physical deterioration, theft, or loss, (3) prevent the purchase of assets already on hand, and (4) determine the full costs of the programs that use these assets. DOD's deficiencies in these areas will also have an adverse affect on its ability to measure progress against the indicators set out in its recent Performance Plan, covering fiscal year 1999, prepared in response to the requirements of the Government Performance and Results Act. For example, in its plan, DOD sets out indicators of (1) achieving a 90 percent visibility rate for materiel and (2) reducing secondary inventories[3] from $70 billion to $48 billion. Weaknesses identified in DOD's logistical systems, as well as its inability to accurately determine costs, may hamper its ability to reliably determine its performance against either of these and other indicators.

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[3]Secondary inventories are repairable and consumable items in storage at depots and installations.

Military Equipment Accountability and Visibility

DOD's investment in military weapons systems represents an estimated $635 billion of the federal government's total property, plant, and equipment reported at about $1 trillion. Accountability over these critical assets entails knowing, for each asset category, how many exist, where they are located, and their value. Overall, the auditors found that DOD's logistical systems could not be relied upon to provide this basic information. DOD relies on these systems to support not only the services' financial reports, but also to provide data on the number and location of military equipment and support operational requirements as well.

As a result, senior DOD officials did not have accurate information to use in making operational decisions or for financial reporting. To further test the accuracy of this critical logistical information, GAO, along with auditors from the offices of the DOD Inspector General and the military service audit agencies jointly conducted tests of logistical systems supporting about 80 percent of DOD's reported military equipment, by attempting to trace selected military equipment items recorded in those systems to the assets in the field. Because of the sensitive nature of the equipment selected from the systems for these existence tests, the tests were designed to either "pass" or "fail." For a number of critical systems being tested, it was agreed with the military leaders who use those systems, that a "pass" would result only where all assets selected from the system were found. For other systems, which generally carry information on less critical assets, it was agreed that up to two errors could be identified with the system still receiving a passing grade. The results of auditors' reviews and tests of the reliability of information on the numbers and locations of military equipment and each of the military service's key logistical systems are described below.

Navy

The Navy does not have a central system that supports both financial reporting and worldwide visibility over various categories of military equipment. Instead, it relies on various systems and publications to provide this information. As part of the joint tests, described previously, of DOD's reported military equipment, these systems and publications were tested to determine if reported assets actually existed.

Auditors tested recorded information for 11 categories of Navy military equipment. The Navy's systems failed for three of the 11 categories of tested military equipment—active boats, inactive service craft, and uninstalled engines. This means that the systems used to provide visibility over these mission critical items were not reliable.

- Active boats. The Combatant Craft and Boat Support System (CBSS), is used to provide senior Navy military officials visibility over the number and location of the Navy's "boats." These boats range in value up to$8 million and include landing craft and other boats used to assist in carrying out activities such as amphibious operations, aircraft rescues, drone recoveries, and mine countermeasures. The tests for these mission critical assets– for which a "pass" allowed zero errors– found that 2 of the 45 boats selected for examination were included in CBSS as available for use, even though they had been disposed of or sold.

- Uninstalled engines: The Navy uses information from its logistical system for engines–Aircraft Engine Management System–to track all Navy aircraft engines, both installed and uninstalled. In testing this system–for which a "pass" allowed up to two errors–auditors were unable to verify the existence of 10 of the 105 sampled uninstalled engines. These 10 engines were valued at up to $4 million each.

- Service craft. Service craft are waterborne utilitarian craft not classified as ships or boats, which provide services to the fleet in harbors, ports, and at sea. The Navy uses the Naval Vessel Register–an electronic publication updated weekly that includes custodian, fleet assignment, and condition information on the Navy's ships and service craft. This publication is relied on to maintain visibility of these assets. Auditors' tests–for which a "pass" allowed up to two errors–revealed that 6 of the 79 inactive service craft tested could not be located. Fifteen other service craft were sold or otherwise disposed of prior to the audit testing, but remained in the Naval Vessel Register coded as "Inactive." An "Inactive" coding indicates that an item was taken out of active service but was retained for possible use in meeting rapid mobilization requirements. An asset may also be placed in this category pending disposal. Table 1 shows the service craft that were no longer in the Navy's possession.

Table 1: Service Craft Erroneously Included in the Naval Vessel Register

Type of Service Craft	Reported Value (in thousands)	Number Sold or Disposed
Harbor Tugs	$583 - $873	3
Barges and Lighters[a]	$20 - $414	16
Ferry Boat or Launch	$843	1
Floating Crane	$468	1
TOTAL		21

[a]Lighters are barges which are used in port to transport personnel, goods, etc. from ship to ship or ship to shore.

In addition, auditors' tests of systems supporting inactive ships and boats, which were permitted up to two errors before the systems failed due to the less critical nature of these military equipment categories, showed that these systems included one inactive cargo ship and two inactive boats which had been disposed of or sold. The Naval Audit Service is in the process of developing a report containing recommendations for actions to address these critical issues.

Army

The Army relies on a central logistics system, the Continuing Balance System-Expanded (CBSX), to maintain worldwide visibility for all military equipment, including the Army's most critical war fighting equipment (national defense assets including tanks, cannons, armored personnel carriers, and aircraft). The system is intended to provide accurate, timely, and auditable equipment status information necessary for direct troop support. The central system should mirror the official accountable records of equipment balances, such as property book records maintained by various Army activities, including Army divisions that may be deployed, depots that repair or upgrade equipment, and storage sites.

The Army calculates a compatibility rate to measure the extent to which the central system and the property book records agree–with a 98 percent compatability rate as a goal.[4] As of July 1997, the Army reported an Army-wide compatibility rate of about 92 percent. However, in January 1998, we reported that the 92 percent rate is overstated

[4]Army calculates the compatibility rate as a ratio of the total number of adjusted equipment items to the total number of equipment items on hand, expressed as a percentage.

because Army does not include all the adjustments that are made to records.[5] If these adjustments were included in the calculation, the Army-wide rate would fall to about 87 percent.

In addition, we reported that the compatibility rate calculation does not provide a complete indicator of the central system's accuracy because it does not include errors associated with equipment that is in-transit between locations. These in-transit errors are significant–when they occur, the Army loses visibility over this equipment. In June 1996, the Army Audit Agency reported that as of July 31, 1995, 69 percent of the 1,135 open in-transit records in the central system it analyzed were invalid. The auditors identified a number of reasons for the invalid in-transit records, including system interface problems, use of duplicate unit identification codes, and shipments that were redirected to another destination after the shipment was initiated.[6]

We recently analyzed a statistically projectable sample of adjustments made to data in the central system to bring it into agreement with data in the Army's primary property book system. Our analysis showed that over 40 percent of the adjustments were needed because of transactions that had been recorded in unit level property books, but not received by the central system. Until these adjustments were made, assets including Howitzer cannons, M-16 rifles, and cargo trucks were not reflected in the central system. For example, one of the adjustments was for a Howitzer M-119 cannon, used for firing shells at a high angle of elevation to reach a target behind cover or in a trench and valued at approximately $423,000, that had been recorded in a deployed unit's property book, but the transaction was not received by the central logistical system.

These problems are long-standing. In a 1993 study,[7] we found that the Army did not maintain reliable information on the types, quantities, and locations of its equipment. For example, we found that one unit's equipment records indicated having 220 more tanks than were being reported in the central system. In another instance, a unit reported 18 advanced attack helicopters which were not recorded in the central system. Such discrepancies not only result in financial reporting misstatements, but, as DOD acknowledged in its "Lessons Learned" report following Desert Storm, inaccurate or unreliable central system data can impair equipment distribution decisions. As a result, some units received equipment in excess of their authorized levels, while other units were not provided critically needed equipment. Our recent report identified specific reasons

[5] Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

[6] Financial Reporting of Equipment In Transit (U.S. Army Audit Agency, AA 96-156, June 17, 1996).

[7] Financial Management: Army Lacks Accountability and Control Over Equipment (GAO/AIMD-93-31, September 30, 1993).

for discrepancies between central system and unit accountability records and made nearly 20 detailed recommendations, including suggestions to (1) ensure that the central system receives applicable property book transactions, (2) correct software problems, (3) improve the transaction audit trail, and (4) enhance the training of property book officers.[8]

Because of the known problems with the Army's central system, the auditors focused the existence tests, described previously, of the Army's recorded assets on its unit-level property books which are used to provide information to the central system, and on other logistical systems containing asset information. The tests were designed to validate the existence of assets for the five categories of military equipment that comprised 70 percent of the reported value of Army mission assets. These categories are aircraft, combat tracked vehicles, communication equipment, missiles, and missile support equipment. The data in the Army's property books passed the auditors' tests for existence for each of the five asset categories. However, the auditors found two errors in the missile support category, one of which was a critical military equipment item.

Specifically, one missile launcher for an AVENGER weapon system could not be located. The AVENGER weapon system is a lightweight, highly mobile surface-to-air missile/gun system which can be mounted on a High Mobility MultiPurpose Wheeled Vehicle (HMMWV). Each AVENGER launch system costs approximately $1 million. Army officials' explanation for problems in locating the missile launcher was that the serial number listed in the Army's records for the AVENGER missile launcher was in fact the serial number of the HMMWV, and that the launcher had been removed from the HMMWV. As of April 9, 1998, this launcher had not been located. The Army Audit Agency's draft report on "Accountability for Army Mission Equipment" recommends that the Deputy Chief of Staff for Logistics establish specific criteria and procedures for recording serial numbers in unit property books for high-dollar value components of equipment items.

Air Force

Our recent work identified problems with the Air Force's Reliability and Maintainability Information System (REMIS), which is intended to provide worldwide visibility over its equipment, such as aircraft and missiles, and timely maintenance and logistical information. This central logistical system is used to support Air Force field and operational commanders. Over 1,700 users have access to various modules of the central system to support a variety of activities including strategic planning, asset accountability, and budgeting. As with the Army's central logistical system, the accuracy of the data in the Air Force system is important not only for financial reporting, but also for effective

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[8]Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

asset control and program management. The Air Force central system includes three databases: (1) an inventory table, which identifies equipment by serial number and type. (2) an assignment table, which shows the assigned command and mission for aircraft and missiles by serial number, and (3) a possession table, which identifies the physical location of aircraft and missiles by serial number. These databases generally should be consistent. However, we reported[9] in August 1997 that our analyses of these three databases identified a number of inconsistencies in the number of aircraft and missiles reported. For example, our findings included the following.

- Over 200 ground launched cruise missiles were identified in the assignment table that were not included in either of the other central system databases. According to the system program office, these missiles were destroyed years ago as part of a treaty with the Soviet Union.

- Twelve aircraft and missile records were erroneously included in the inventory table (they did not appear in the assignment or possession table). It was determined that these records did not represent actual equipment and therefore should have not been in the central system inventory table.

- Twenty-five aircraft and eight air-launched cruise missiles were included in the central system inventory and assignment tables, but were not in the possession table. These assets were not reflected in the possession table because the table had not been updated to reflect asset transfers from one location to another.

- Duplicate records for 10 helicopters were included in the central system inventory database. This error occurred as the result of improper data entry when making modifications to type/model/series information.

We recommended short-term actions the Air Force could take to improve the accuracy of aircraft and missile data in its central logistical system. Such actions included making regular comparisons and analyses of the central system databases and researching and correcting any inconsistencies, such as the mismatches we identified.

In addition, the systems the Air Force relied on to account for and control military equipment "passed" the existence tests described previously. However, the auditors identified errors, which, although within the acceptable limits of the auditors' tests for a passing mark on the equipment reported in the system, may raise concerns over the reliability of location information on critical items in the Air Force's arsenal of military equipment. Specifically, as part of the auditors' tests, they determined that (1) two engines included in the logistical system records as uninstalled engines were actually

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[9] Financial Management: Accuracy of Air Force and Missile Data Could Be Improved (GAO/AIMD-97-141R, August 15, 1997).

installed in aircraft several years ago, and (2) an older model C-130 cargo plane remained in the logistical records even though the aircraft had been destroyed a few years ago at a contractor facility during corrosion testing. In addition, while not specifically part of the auditors' financial audit testing, they noted that the Air Force's logistical records on the location of 46 engines, valued at $91,000 each, were incorrect. Air Force officials informed the auditors that erroneous information was included in the logistical systems primarily because the contractors had not updated the records when these assets were transferred from the contractor's facility. The auditors offered specific suggestions to correct these deficiencies noted as part of their audit tests.

Improvement Efforts

Both the Army and Air Force have indicated that they either have taken, or are taking, actions to address auditor concerns and improve these critical systems. To improve its central logistical system, the Army established an Improvement Team to develop initiatives related to data accuracy in its central logistical system and hired a contractor to carry out those initiatives. DFAS and Air Force officials indicated that they had completed actions to address our recommendations on specific actions to improve the Air Force system. We plan to follow up the effectiveness of these actions as part of our fiscal year 1998 financial audit work at DOD. The Navy has not yet indicated what actions it will take.

Equipment Valuation

Auditors have had long-standing concerns that the reported value of DOD's military weapons systems was inaccurate. Recent audit results demonstrate that DOD continues to experience problems in this area. For example, Army auditors recently reported that limited testing of the recorded value of selected military equipment items revealed an understatement of more than $10 billion as a result of the Army not updating unit price information to reflect standard price. The Army adjusted its financial statements for that amount, but Army auditors reported that the account balance was still misstated by an unknown amount for the equipment items that were not tested.

The Department's most recent annual report to the President and the Congress describes the significance of DOD's inability to develop reliable cost information. Specifically, the report cited the lack of a cost accounting system as the single, largest impediment to controlling and managing weapon system life-cycle costs, which include acquisition costs, as part of DOD's acquisition reform initiative to acquire products "that work better and cost less." In this regard, DOD identified as a specific goal, establishing an implementation plan for a cost accounting system that provides visibility over weapon system life-cycle costs. Without accurate information on the acquisition costs of weapon systems, neither DOD officials nor the Congress can make fully-informed decisions about which weapons or how many to buy. Moreover, DOD management needs accurate cost information to monitor costs as weapon systems are being built, especially for those weapons for which Congress imposes cost limits.

Unreliable Amounts Reported for General Property, Plant and Equipment

In addition to military equipment, DOD is responsible for almost one-half of the government's general property, plant and equipment (PP&E).[10] Long-standing issues affecting the reliability of reported general property amounts include DOD's inability to ensure that all its assets are properly reported and valued. DOD auditors restated again in recent audit reports that the billions of dollars reported for real property (land, buildings, facilities, capital leases, and improvements to those assets) and non-military equipment, such as trucks, telecommunications systems, and computers, were unreliable due to valuation errors, omissions of assets, system deficiencies, or other recording errors, such as duplicate reporting.

With regard to valuation, auditors were unable to verify the reported amount of DOD's property. In general, documentation supporting these values no longer exists or cannot be located. In addition, obviously erroneous valuation data are not being corrected. For example

- At one location tested, Navy auditors identified 49 buildings valued at a total of $25 million that were recorded at a zero or one dollar value in the system used to obtain the plant property values for the Navy's fiscal year 1997 financial statements.

- The Air Force's fiscal year 1997 financial statements were understated by $189 million because of pricing errors entered into the system for fire trucks. The fire truck amounts were based on a unit price of $1.03 instead of the actual cost of over $470,000.

In certain cases, some DOD general property is being omitted from reports. For example, DOD auditors reported problems at each military service related to DOD's inability to properly identify and report its capital leases. Air Force and Navy auditors determined

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[10]Statement of Federal Financial Accounting Standards No. 6 states that general PP&E is any property, plant, and equipment used in providing goods and services. It typically has one or more of the following characteristics: (1) it could be used for alternative purposes (e.g., by other Federal programs, state, or local governments, or non-governmental entities) but is used to produce goods or services, or to support the mission of the entity, (2) it is used in business-type activities, or (3) it is used by entities in activities whose costs can be compared to those of other entities performing similar activities (e.g., Federal hospital services in comparison to other hospitals).

that capital leases with an estimated total value at $493 million were omitted from Air Force and Navy fiscal year 1997 financial statements.

Finally, DOD auditors have identified the lack of integration of financial accounting and property accounting systems as a major factor contributing to unreliable general property reporting. Accordingly, the DOD Comptroller designated the Defense Property and Accountability System (DPAS) as the property accounting system for all DOD real and personal property in order to bring DOD assets under proper accountability and financial control. We recently reported[11] that the DOD-wide system, as functionally designed, can provide financial control and generate information to account for most general property. However, we also reported that if not properly implemented, as was the situation at the Defense agency we reviewed, the DOD-wide system would not ensure financial control and accurate reporting of general property. Furthermore, while the DOD Comptroller has stated that this system must be implemented across DOD by the year 2000, no specific plans to accomplish this goal have been developed. The responsibility for implementing this system was recently turned over to the Defense Logistics Agency. Our report made 10 detailed recommendations to ensure that financial control and accountability over general property is attained. These include developing an implementation plan with milestones for DPAS, revising the handbook accompanying the system, and modifying the software to update it for new accounting standards.

Capitalization Threshold

DOD's ability to accurately report its property, plant, and equipment values has been further hampered by the 20-fold increase in its capitalization threshold from $5,000 in 1991 to $100,000 in 1996. Prior to fiscal year 1998, DOD policy required DOD components to capitalize an asset when its acquisition cost or similar cost exceeded the capitalization threshold in effect at the time of acquisition. Beginning in fiscal year 1998, however, DOD components–other than working capital fund activities–are required to apply a single $100,000 capitalization threshold to assets, irrespective of the threshold that existed at the time of purchase. Under this policy, all general PP&E assets, previously capitalized by non-working capital fund activities at thresholds less than $100,000, will be expensed in fiscal year 1998. Recognizing the effect this policy would have on operations, working capital fund activities are required to apply the capitalization threshold only to newly acquired assets, beginning in fiscal year 1998, and to retain, on their financial records, existing capitalized assets even though the assets may have been capitalized at a level of less than $100,000.

Prior audit reports have disclosed that higher capitalization thresholds have not been uniformly applied throughout DOD, resulting in inconsistencies in asset reporting and the

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[11] Financial Management: DOD's Approach to Financial Control Over Property Needs Structure (GAO/AIMD-97-150, September 30, 1997).

omission of billions of dollars in assets from DOD financial reports. As a result of the higher capitalization threshold, billions of dollars of assets have been expensed—effectively removing them from accounting control. For example, Navy auditors estimate that if the $100,000 capitalization threshold were applied to the Navy's March 1996 nonmilitary equipment balance of $6 billion, over $1 billion would be eliminated. In a letter to DOD in March 1997, we estimated that at least $5 billion of the Army's equipment would have been excluded from the Army's fiscal year 1996 financial statements if the $100,000 threshold was retroactively applied. Eliminating these items from financial control and the accountability imposed by annual audits is particularly detrimental because, as discussed earlier, financial audits have repeatedly found that DOD's detailed property records are not accurate.

Further, use of this high capitalization threshold adversely affects the measurement of operating costs. Billions of dollars of assets are expensed in their year of acquisition, as opposed to the cost of those assets being allocated over the life of the asset. For example, as a result of implementation of high capitalization thresholds, thousands of tractors costing at least $70,000 each and numerous types of industrial equipment have been written off in the year of acquisition. In addition, expensing these costs makes it harder for DOD to compare its cost to the private sector, which is required to capitalize such items. For example, this impairs the ability of DOD and oversight officials to make informed decisions on issues where comparative costs are a significant factor, such as in deciding whether to outsource specific functions.

We are analyzing the effect of DOD's capitalization policy on its operational and program costs and asset accountability and will be continuing to discuss our views with DOD managers.

Inventory Cannot Be Verified

DOD inventory[12] includes ammunition (such as machine gun cartridges, rocket motors, and grenades), consumables (such as clothing, bolts, and medical supplies), stockpile materials (such as industrial diamonds, rubber, and tungsten), and repairable items (such as navigational computers, landing gear, and hydraulic pumps). DOD's inability to effectively account for and control its reported $170 billion investment in inventories has been an ongoing area of major concern. We are continuing to monitor DOD inventory management as one of the areas that we consider as high risk because of its vulnerability to waste, fraud, and abuse. One area of inventory management that has been a long-standing concern is excess inventories. In February 1997, we reported our estimate that

[12]Statement of Federal Financial Accounting Standards No. 3 defines several categories of inventory. DOD primarily has inventory held for sale, operating materials and supplies, and stockpile materials. For purposes of this testimony, we refer to all categories as inventory.

about half of DOD's $70 billion in secondary item inventories[13] at the end of fiscal year 1995 was excess to current operating requirements and war reserves.[14]

Auditors continue to find that DOD's inventory management and control systems and practices are plagued with serious problems, including

- on hand quantities that do not agree with the records,
- an inability to reliably determine inventory values,
- deficiencies in information on the condition of inventories,
- a significant amount of inventory excluded from overall logistics management visibility as well as financial reporting, and
- an inability to effectively account for and control intransit inventories.

On-hand Quantities Do Not Agree With Records

Auditors have issued a number of reports over the past several years detailing extensive discrepancies between the results of physical counts of inventories actually on-hand and quantity information recorded in inventory records. For example, in their fiscal year 1997 audit opinion on the Army's Working Capital Fund, Army auditors cited unacceptable error rates in prior years' testing of inventory records.[15] The DOD IG reported an overall 24 percent error rate at DOD's primary storage locations as a result of physical counts it performed in fiscal year 1996.[16] The auditors' examination of inventories in the fiscal year 1997 financial statements found this condition continued. For example:

- Navy auditors performed physical counts at 13 major Navy storage locations. Their preliminary results indicate that the quantities actually on-hand differed from inventory records 23 percent of the time. Out of 652 stock numbers tested, 150 had count quantities that differed from the inventory record quantities.

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[13]Secondary inventories are repairable and consumable items in storage at depots and installations.

[14]High-Risk Series: Defense Inventory Management (GAO/HR-97-5, February 1997).

[15]Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. AA 98-111, February 13, 1998).

[16]Inventory Record Accuracy and Management Controls of the Defense Logistics Agency Distribution Depots (DOD IG Report No. 98-019, November 10, 1997).

- Air Force auditors found that Air Force records showed $4.5 billion of Air Force ammunition was stored at Army locations as of the end of fiscal year 1997, but Army records showed only $2.5 billion.[17] Of the $2 billion difference, the auditors could only resolve $864 million, which was the result of Air Force records showing that it had 14.5 million smoke rockets (used to mark targets) at an Army storage location, while only 1,450 were actually on-hand at that location. The item manager was not aware of this difference until the auditors pointed it out.

As a result of these deficiencies in recorded inventory quantities, DOD managers do not have reliable information to make purchase decisions or to fully recognize and eliminate excess inventories and related storage costs. For example, in February 1997, we reported that DOD had ordered $11.3 million in additional items, such as circuit card assemblies, computers, and hydraulic pump valves, that already were in excess supply.[18] In June 1996, we reported that about $31 billion of DOD's reported $80 billion of ammunition was excess.[19] In January 1997, we reported that DOD could save about $382 million annually in holding costs by eliminating an estimated $2.7 billion in inventories not needed to meet current operating and war reserve requirements.[20]

Inventory Values Questionable

Federal accounting standards require inventories to be valued based on historical cost, or a method that will approximate historical cost. DOD does not have historical cost data on inventories. Accordingly, DOD developed an agency-wide model in 1994 to approximate historical cost. The model requires adjustments to recorded inventory values to arrive at the estimated historical cost. These adjustments are a key factor in determining the working capital funds' cost of operations.

Auditors have been unable to evaluate the reasonableness of reported inventory values due to errors and wide swings in the dollar value of adjustments made to value inventory at historical cost using this model. For example, the application of the model in Navy for its fiscal year 1996 financial statement reporting resulted in about an $8 billion adjustment to Navy's Working Capital Fund inventory and in a net loss of $3.4 billion. However,

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[17]Opinion on Fiscal Year 1997 Air Force Consolidated Financial Statements (AFAA Report No. 97053009, February 27, 1998).

[18]Defense Logistics: Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

[19]Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996).

[20]Defense Inventory: Spare and Repair Parts Inventory Costs Can Be Reduced (GAO/NSIAD-97-47, January 17, 1997).

during 1997, DFAS later identified a $3.9 billion error in how the model was applied to the fiscal year 1996 inventory balances, which caused that year's ending inventory balance to be understated by the same amount.

Further, the model has undergone frequent changes that have not been well-documented and, therefore, the impact of the changes has been difficult to follow. Nevertheless, the changes could have been one reason that the Navy's reported inventory balances fluctuated significantly between fiscal years 1995 and 1997. For example, the Navy's Working Capital Fund reported inventory balances were about $13 billion in fiscal year 1995, $10 billion in fiscal year 1996, and $13 billion again in fiscal year 1997.

As a result, the model DOD is using to value inventories has yet to demonstrate that it can reliably approximate historical cost as required by standards. DOD's September 1997 working capital funds improvement plan recognized the need to properly value inventories at historical cost. However, until DOD can develop and validate such a model or capture its inventory costs, DOD will continue to have little assurance that it can develop and report accurate net operating result information–a key factor in setting the prices DOD's working capital fund operations charge their customers. Auditors are working with DOD to determine if the model can be modified to provide more accurate estimates as an interim measure until DOD obtains actual inventory costs.

Assets With Unknown Condition

DOD's financial statements are required to provide information on the condition of inventories. For example, items held for repair should be segregated and reported at values reduced by the costs of bringing those assets up to serviceable condition. However, Army auditors reported that the Army's fiscal year 1997 Working Capital Fund financial statements did not properly report inventory held for repair.[21] In addition, we reported in December 1997 that the Air Force had over 400,000 secondary items valued at $2.4 billion for which it had not determined the usability or condition.[22] For about 64 percent of the almost 2,000 items we reviewed, we found that Air Force records were not updated to reflect the item condition for over 1 year, and in some instances had not been updated for over 6 years. Lacking reliable information on inventory condition, DOD may not have an accurate picture of the amount needed to bring these items to a serviceable state, which could affect readiness or may result in DOD incurring unnecessary storage costs for those items for which it is not economically feasible to repair and should be disposed of.

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[21] Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. 98-111, February 13, 1998).

[22] Defense Inventory: Inadequate Controls Over Air Force Suspended Stocks (GAO/NSIAD-98-29, December 22, 1997).

Inventories Not Reported

As disclosed in our recent report on the results of our audit of the U.S. government's consolidated financial statements, an estimated $9 billion of known military operating materials and supplies were not reported, including inventories on Army installations, at Navy facilities, and on Navy ships. Further, as part of their fiscal year 1997 audit, Army auditors found that Army records were understated by $248.9 million because munitions balances in Kuwait and those held by a contractor were not reported.[23] In the case of the contractor, the auditors confirmed that the contractor's records showed 3,873 more rocket pods (a rocket pod contains 12 surface-to-surface rockets and is part of a mobile rocket launching system) than the Army's records. This variance, representing about 14 percent of the total 27,766 rocket pods the Army has in its inventory, occurred because the Army relied on manual reporting procedures from the contractor. This is not a new problem. For example, in its fiscal year 1996 audit, the Naval Audit Service found that the Navy's reported ammunition balances were understated by $20.4 billion because the source Navy used to prepare its financial statements did not include all ammunition owned by the Navy.[24]

The adverse effect of not having information on these inventories was highlighted in our March 1998 report on our analysis of Navy financial data deficiencies.[25] We discussed a number of areas in which logistics systems' financial deficiencies not only adversely affected the reliability and usefulness of the Navy's financial reporting but also had significant programmatic or budgetary implications. For example, to determine Navy-wide inventory requirements, responsible managers must have accurate, reliable information on the quantities of inventories on ships, including any quantities in excess of needs. However, we reported that information on almost $8 billion of inventories on-board ships were omitted from the data used from financial statement reporting and as the starting point for the development of budget requests for additional inventories.

As a result, there was a substantially increased risk that Navy may have requested funds to obtain additional unnecessary inventories because responsible managers did not receive information on excess inventories that were already on hand in other locations. For example, in our August 1996 report, we identified unnecessary Navy spending of at least $27 million in fiscal year 1995 and forecasted spending which could result in the

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[23]Army's Principal Financial Statements for Fiscal Year 1997 and 1996 – Financial Reporting of Wholesale Munitions (AAA Report No. 98-98, February 5, 1998).

[24]Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Internal Controls and Compliance With Laws and Regulations (NAS Report No. 029-97, April 5, 1997).

[25]CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies (GAO/AIMD-98-56, March 16, 1998).

Navy incurring another approximately $38 million in the future for items already available at other locations.[26]

Poor Accounting for Intransit Inventories

In their audits of fiscal year 1997 working capital fund financial statements, auditors were not able to confirm the intransit inventory balances, which are included in the reported overall inventory balance on hand. For example, Army auditors found that a reported $598 million of inventory intransit from vendors was misstated by an unknown but material amount due to problems with processing receipt notifications.[27] Air Force auditors could not validate $11 billion of inventories at contractor repair facilities and intransit between contractors and Air Force installations because the systems did not maintain supporting records.[28]

We also recently reported on problems with verifying intransit inventory balances. In February 1998, we reported that the $5.2 billion of intransit secondary item inventory shown in DOD's fiscal year 1996 Supply System Inventory Report is questionable because (1) the Air Force did not include $1.3 billion of intransit repairable items, and (2) DOD did not have receipt notifications for 12.4 million shipments outstanding for an average of 145 days–approximately 1.4 billion items–out of 21 million shipments it initiated.[29] The logistical systems supporting this report also are the source of financial information.

Taken together, these inventory control and accountability deficiencies also serve to undermine the Department's ability to reliably meet established performance objectives. For example, performance indicators were set out in the Department's recent performance plan, including reductions in retail-level inventories, such as repairable and consumable items at bases, from $14 billion in fiscal year 1996 to $10 billion in fiscal year 2001, and reductions in supply inventories, such as repairable and consumable items in storage, from $70 billion in fiscal year 1995 to $48 billion in 2003. These performance indicators do not address the remaining balance of the reported $170 billion of inventory, including ammunition and other operating supplies. Until DOD can reliably account for both the quantity and value of its substantial investment in inventories, its ability to assess its progress in meeting such goals will be impaired.

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[26]Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996).

[27]Army Working Capital Fund Principal Financial Statements for Fiscal Year 1997 (AAA Report No. 98-111, February 13, 1998).

[28]Opinion on Fiscal Year 1997 Air Force Working Capital Fund Financial Statements (AFAA Report No. 97068043, February 27, 1998).

[29]Department of Defense In-Transit Inventory (GAO/NSIAD-98-80R, February 27, 1998).

REPORTED ENVIRONMENTAL/DISPOSAL LIABILITY IS SIGNIFICANTLY UNDERSTATED

DOD has not yet fully implemented the federal accounting standard that requires it to recognize and report liabilities associated with environmental clean up and/or disposal of its assets, including ammunition, national defense assets,[30] military training ranges, and chemical weapons. While DOD reported $38.7 billion in estimated environmental cleanup and disposal liabilities in its fiscal year 1997 financial statements for environmental restoration of active and inactive bases, cleanup of formerly used sites, and cleanup and disposal of certain chemical weapons, it did not estimate environmental cleanup and disposal costs associated with military weapons systems or training ranges. As a result, DOD's undisclosed liability in this area is likely understated by tens of billions of dollars.

One of the new accounting standards[31] requires recognition of a liability for any probable and measurable future outflow of resources arising from past transactions, if those costs can be reasonably estimated. These requirements apply to many DOD assets, including its weapons systems, which contain hazardous materials and waste that must be removed and disposed of when inactivated. The new federal accounting standard was issued more that 2 years ago to allow agencies ample time to develop implementing policies and procedures prior to its fiscal year 1997 implementation date. The Congress has also recognized the importance of accumulating and considering such information. The National Defense Authorization Act for Fiscal Year 1995 requires the Secretary of Defense to determine, as early in the acquisition process as feasible, the life-cycle environmental costs for major defense acquisitions programs, including the materials to be used and methods of disposal. The life-cycle cost estimates are required before proceeding with the major acquisition.

Because of the importance of this information and because of our responsibility to audit the U.S. government's consolidated financial statements beginning with fiscal year 1997, we undertook a series of reviews to assist DOD in its efforts to meet the requirements of the new federal accounting standard. We found that, while DOD has not yet estimated its disposal liability for all assets, including national defense assets, information is available to estimate these costs. We have reported the following.

- DOD regularly disposes of missiles and includes disposal costs for missiles as part of its annual budget request. Using available information, the military services

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[30]Includes weapons systems such as submarines, ships, aircraft, missiles, and combat vehicles.

[31]Statement of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government.

were able to provide us with estimated disposal costs, ranging from $102 to almost $500,000 per missile for each of four missile types we selected for review.[32]

- Navy management information systems contain data on the costs to inactivate and dispose of nuclear submarines and ships. For example, these systems show that estimated environmental costs associated with inactivation and disposal activities related to a nuclear submarine could range, at a minimum, from $19 million to $61 million. Navy officials also provided a cost estimate that ranged from $807 million to $942 million for the inactivation and disposal of the first Nimitz-class nuclear carrier, if work was begun in fiscal year 1998.[33] Subsequently, they stated that as the Navy gains experience in defueling during the refueling cycles of Nimitz-class carriers, they expect the cost estimate for inactivating and disposing of Nimitz-class carriers could be reduced to about $500 million for the tenth Nimitz-class carrier. Although the Navy has not provided a basis for us to assess the reasonableness of the $500 million estimate, we acknowledge that as the Navy gains experience in the inactivation and disposal of aircraft carriers, cost efficiencies could occur. Ultimately, the estimate will need to be adjusted to reflect actual experience.

- DOD's designated aircraft storage, reclamation, and disposal facility could provide data to compute estimated costs for the demilitarization (ranging from about $7,000 to $105,000 for three of the aircraft we reviewed) and hazardous material removal (ranging from $313 to $123,000 for the five aircraft reviewed) for aircraft systems.[34]

- DOD can use historical cost information on ammunition disposal already compiled as a starting point for estimating the Department's ammunition disposal liability. Using these data, along with inventory quantities provided by the Army, we estimated that the Army's ammunition disposal liability alone could range from about $1.3 billion to $2.1 billion.[35]

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[32]Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

[33]Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Material in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997).

[34]Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997).

[35]Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997).

DOD also faces significant cleanup and disposal costs for its military training ranges. These costs, which are related to clearing the land of unexploded ordnance and other chemical wastes, are also estimable. In a July 1996 study, DOD estimated that $19.5 billion would likely be needed to secure and/or clear inactive, closed, or transferring ranges under current legal requirements; however, DOD did not include any estimate for these costs in its fiscal year 1997 financial statements. Also, this amount should have been, but was not, included in DOD's 1996 Defense Environmental Restoration Program Annual Report to the Congress.

In response to our reports, DOD has stated that, while it generally agreed that estimates could be developed for certain assets, estimates covering all assets would take some time. It added that it has delayed reporting of most of these liabilities because of the time required to develop and implement policy and specific application procedures and reporting guidance.

As the Department begins developing needed policy and specific guidance for the military services on estimating and reporting the disposal liability for assets, our reports identify certain factors that need to be addressed. In addition, because environmental and disposal liabilities represent future outlays, DOD should also consider ways to make this information even more meaningful to decisionmakers. One way to provide a proper context for environmental liabilities would be to provide a table showing estimated outlays by budget period in a footnote to the financial statements. Such a table would show congressional and other budget decisionmakers the potential annual impact of DOD's actions on various budget periods, including those outside the annually submitted Future Years Defense Program. This information could also provide a link between budgetary and accounting information, one of the key objectives of the CFO Act.

REPORTED LIABILITY FOR POST-RETIREMENT HEALTH CARE IS UNSUPPORTED

Under the new accounting standards, DOD is required to calculate and report its estimated liability for providing health care benefits to military retirees and their beneficiaries. DOD provides these benefits through free care at Military Treatment Facilities and through the Tricare program, which is comprised of fee-for-service (CHAMPUS), preferred provider, and HMO plans.

DOD did not accumulate the data necessary to accurately estimate its military post-retirement health benefits liability. Specifically, DOD used unaudited budget information, instead of the required cost data, to calculate its $218 billion estimated liability. In addition, DOD did not accumulate current or complete historical claims data to support its calculation. These problems significantly impair DOD's ability to determine the full cost of its current operations or the extent of its actual liabilities.

According to both DOD actuaries and independent actuaries under contract to DOD, the current cost of providing health care cost is very significant to the liability calculation–if costs are understated or overstated by a percentage point, the liability will be understated or overstated by approximately the same percentage. However, DOD did not accumulate actual cost data for its Military Treatment Facilities. Instead, DOD estimated health care spending using budget obligation data and used this information in the calculation. While budget obligations represent funds committed during a period, they are not equivalent to full cost data. For example, the costs of the treatment facilities themselves may not be fully captured nor some personnel costs such as future pension expenses.

DOD did not obtain a significant portion of health care claims data. For outpatient claims, which comprise over one-third of the dollar value of all claims, data were available from only 15 of the 121 Military Treatment Facilities. The actuaries assumed that the 15 were representative of the entire 121, which resulted in an unquantifiable error in the liability calculation. Finally, the actuaries did not obtain the most current data available; instead, claims data from fiscal year 1994 were the most recent used in the calculations for the fiscal year 1997 liability.

COST OF DOD OPERATIONS NOT ACCURATE

As stated in our report on the results of our audit of the U.S. government's consolidated financial statements, the government was unable to support significant portions of the more than $1.6 trillion reported as the total net costs of government operations. DOD accounts for about $250 billion of this amount. The previously discussed material deficiencies in DOD's ability to report assets and liabilities and the lack of effective reconciliations, as discussed later, all affect the department's reported net costs. Specifically, as previously discussed, the accuracy of DOD's operating costs is materially affected by DOD's inability to (1) properly value and capitalize its facilities and equipment, (2) properly value its inventory, (3) identify its environmental and disposal costs, and (4) determine its costs associated with post-retirement health-care for military personnel. Further, as discussed in the following sections, DOD's inability to properly identify and eliminate interagency transactions, reconcile balances with Treasury, and record all of its disbursements are additional factors in the incomplete picture of DOD's costs.

DOD CANNOT IDENTIFY INTERAGENCY TRANSACTIONS

To make the consolidated governmentwide financial statements balance, Treasury had to record a net $12 billion item on the Statement of Changes in Net Position, which it labeled unreconciled transactions. This out-of-balance amount was the net of more than $100 billion of unreconciled transactions–both positive and negative amounts–which Treasury attributed largely to the government's inability to properly identify and eliminate transactions between federal government entities.

In order to portray DOD as a single entity and the federal government as a single economic unit, certain transactions that occur between entity components must be identified and eliminated. Without proper eliminations, certain assets, liabilities, revenues and expenses are double counted or otherwise misstated. However, DOD has acknowledged that it cannot reliably identify and eliminate interagency transactions, whether between individual DOD components or between DOD and other federal government entities.

For the consolidated governmentwide financial statements, DOD identified its side of interagency transactions for elimination without reconciling its accounts with other federal government entities. Therefore, DOD had no assurance that it had identified the correct amounts and that a corresponding revenue, expense, asset or liability had been identified by the transaction partner. Improper eliminations can result in significant errors in financial statement reports. For example, as part of the nearly $300 billion of interagency transactions reported to Treasury, DOD identified $59 billion of program and operating expenses for elimination but later could not justify $42 billion as interagency transactions. As a result, Treasury had to adjust the consolidated net cost statement to correct this error. If Treasury had not made the necessary adjustment, the consolidated Statement of Changes in Net Position, which currently shows the government's costs exceeded its revenues by $15 billion, would have indicated that the government's revenues exceeded its costs by $27 billion for fiscal year 1997.

Because improving DOD systems will be a long-term endeavor, we are continuing to work with DOD, OMB, and Treasury to develop an acceptable interim process to resolve problems in accurately accounting for and reporting interagency transactions.

DOD HAS BILLIONS OF UNRECONCILED CASH ACTIVITY

As discussed in our report on the results of our consolidated audit of the federal government, several major agencies are not effectively reconciling their transactions. DOD, with nearly half of the federal government's discretionary spending, is one of those agencies. These reconciliations–similar in concept to individuals reconciling personal checkbooks with a bank's records each month–are a key control to ensure that agencies' and Treasury's records agree on the amount of funds spent and that remain available, as well as to ensure that all transactions are recorded to capture the costs of an agency's activities.

As important as these reconciliations are to all federal agencies, these are critical for DOD. This is because authorized transactions are often charged to DOD's appropriation accounts by entities not directly responsible for the appropriations. For example, the Army may write a check to pay a Navy vendor and cite a Navy appropriation account.

An effective reconciliation of DOD's and Treasury's records requires not only identifying differences, but researching and recording appropriate adjustments in the accounting systems. DOD has been unable to carry out these critical reconciliations because of

- at least $4 billion in differences between checks issued by DOD and reported to Treasury,

- an indeterminable dollar amount of transactions in suspense accounts, which are to be used to hold transactions temporarily until the agency can determine the appropriate accounting treatment, and

- a reported $22 billion in problem disbursements.

Differences in Checks Issued

DOD disbursing offices write thousands of checks daily to pay the Department's bills. Each month, the disbursing offices provide Treasury with an accountability report that shows the total amount of checks disbursed, by appropriation, for that reporting period. For the total reported amount of checks disbursed, offices provide Treasury with computer listings of individual checks written and their amounts throughout the month and after each month end. Treasury compares the accountability report totals to the total of the computer listings. Treasury also compares the individual checks on the computer listings to the individual checks that have been paid by the Federal Reserve System. Treasury reports any discrepancies to DOD for followup and correction.

Discrepancies between DOD records and Treasury records can occur because of the following situations: (1) the disbursing office makes an error in the accountability report, (2) the computer tapes are incomplete or are not processed by Treasury, and (3) DOD's recorded amount for a check is different from the amount that is paid by the Federal Reserve.

At September 30, 1997, DOD and Treasury records differed by more than $4 billion–$1.4 billion for Army, $1.7 billion for Air Force, $0.7 billion for Navy, and $0.4 billion for other DOD components. However, this $4 billion represents only the net difference of all the positive and negative discrepancies that existed at year-end. For example, any errors in reporting on accountability reports have been offset against errors caused by submission of incomplete computer check listings. Although auditors were unable to determine the total value of the discrepancies, it is likely to be much larger than the reported net amount.

Because DOD had not performed a proper reconciliation with Treasury records, auditors were also unable to determine whose records needed to be adjusted for the differences. While some of these discrepancies could be timing differences, others could be due to errors in DOD recorded amounts or result from an error by Treasury. Furthermore, until these differences are identified, and it is determined whose records require adjustment, DOD is not recording these differences or maintaining control accounts to accumulate these amounts to ensure that all corrections are made.

Indeterminable Amounts Held in Suspense Accounts

In addition to the cash activity discussed above which is not being properly reconciled to Treasury's records, DOD is not properly reconciling its suspense accounts. DOD maintains suspense accounts to record receipt or disbursement transactions for which it is either unable to determine, or has not yet attempted to determine, the correct fund or appropriation citation. When the disbursing office cannot identify the correct fund or appropriation account to provide to Treasury for a receipt or disbursement transaction, the transaction is placed in a suspense account in both DOD's and Treasury's records. These suspense accounts are to be temporary holding accounts that are quickly cleared to permit proper accounting. Until the individual transactions are properly recorded, DOD's budgetary accounts, which tell DOD the status of its available funds, and its accounting records, which provide information on the cost of its programs and activities as well as its assets and liabilities, do not include this information and are therefore inaccurate.

At the end of fiscal year 1997, these suspense accounts totaled $769 million when collections and adjustments were netted against all disbursements. However, this significantly understates the magnitude of the problem. For example, while the Navy had a net balance of $464 million in suspense accounts recorded in its records, the individual transactions, collections as well as disbursements, totaled about $5.9 billion. As a result of not properly recording the $5.9 billion in transactions, the cost of individual programs and activities may be understated because of unprocessed disbursements, while the cost of other programs and activities may be overstated by the unprocessed collections. We have been working with DOD officials and auditors to identify actions DOD should take effectively address this issue in fiscal year 1998.

Problems in Accounting for Disbursements

Problem disbursements is the term used to refer to specific DOD disbursements that have not been matched with corresponding obligations and include the suspense accounts previously discussed as well as unmatched disbursements, in-transit disbursements, and negative unliquidated obligations.[36] Unlike suspense accounts, other problem disbursement categories have been charged to a particular appropriation account in Treasury and in DOD's records when the disbursement is made. However, as with suspense accounts, these other problem disbursement categories may not be reflected in

[36]Unmatched disbursements occur when disbursement transactions are received by the accounting station, but attempts to match them to an obligation are unsuccessful. In-transits are disbursements that have been reported to Treasury but have either not been received or have not been processed by the accounting station. Negative unliquidated obligations occur when disbursement transactions are received, matched to an obligation, and posted to the appropriation by the accounting station, but the recorded disbursements exceed recorded obligations.

the cost of DOD's programs and activities, nor properly reflected in DOD's status of funds because accurate accounting information beyond the appropriation is not available. While DOD has made progress in this area, it still faces a considerable challenge if it is to effectively resolve long-standing deficiencies.

In February 1995, at the date of our 1995 High-Risk report,[37] DOD reported $25 billion of problem disbursements. In May of the following year, DOD reported a reduction in that balance to $18 billion. Examining that reported balance, we issued a report in May 1997 which showed that the balance was understated by at least $25 billion and should actually have been reported at over $43 billion.[38] This occurred primarily because DOD was not reporting all transactions that needed to be resolved, but instead was offsetting collections and adjustments against unrelated disbursements.

In June 1997, DOD began reporting all of its problem disbursements without those offsets. At that time, it reported a balance of over $31 billion in problem transactions. In its latest report, January 1998, DOD reported $22.6 billion in problem transactions. DOD's reports for problem disbursements show that the decrease resulted primarily from actions to clean up old problems. For example, as of January 31, 1998, the Navy had discontinued research and recorded $2.6 billion in obligations to reduce problem disbursements.

While we have not tested DOD's January 1998 problem disbursement report, our work on the financial audit has raised questions about whether all problem disbursements are being reported. We have ongoing work in these areas to determine the extent to which this is occurring and the effect on the financial and budgetary reports.

Because systems problems contribute to the volume of problem disbursements, DOD has identified seven technological initiatives as key elements of its efforts to improve the contract payment process.[39] However, as we reported in our May 1997 report, DOD has not performed the in-depth analysis necessary to fully determine the underlying causes of these problems and therefore identify the most effective solutions and rank specific reforms. As a result, as with its other initiatives, the extent to which these seven technology initiatives will resolve DOD's long-standing disbursement problems is unclear.

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[37] High Risk Series: An Overview (GAO-HR-95-1, February 1995).

[38] Financial Management: Improved Reporting Needed for DOD Problem Disbursements (GAO/AIMD-97-59, May 1, 1997).

[39] Financial Management: Seven DOD Initiatives That Affect the Contract Payment Process (GAO/AIMD-98-40, January 30, 1998).

CRITICAL AREAS MUST BE ADDRESSED TO MEET FINANCIAL REPORTING GOALS

We and the military service auditors have made hundreds of recommendations in the last 2 years alone to help correct DOD's long-standing financial management deficiencies. These recommendations have ranged from specific and detailed actions, such as system edits that could be implemented to prevent certain errors, to broad suggestions to reengineer entire segments of DOD's operations, such as developing a concept of operations for how the department plans to conduct its financial management operations now and in the future. Going forward, we believe that two key issues are critical to DOD's ability to achieve the wide-ranging reforms necessary to address its long-standing financial management deficiencies. Until DOD upgrades the skills of its financial personnel and successfully integrates and consolidates its information systems, the Department may be able to accomplish some slow incremental improvements as we have seen in the past, but the sweeping changes needed to ultimately resolve its long-standing problems will remain outside its grasp.

Establishing a Skilled Financial Management Workforce

One of the key issues facing DOD under the CFO Act is the need to ensure that its financial management staff has the knowledge and skills required to carry out the Department's complex financial management operations. DOD's challenge in this area has been increased by the new set of federal accounting standards and other recent legislative requirements, including the mandate now in place for the development of performance measures that will rely, in part, on financial data. These challenges have highlighted the critical need for targeted technical financial and accounting related training to supplement the on-the-job experiences of DOD's financial managers, if DOD is going to have the cadre of financial managers needed to pass the test of a financial statement audit and comply with the CFO Act.

DOD estimates that it has about 32,000 financial management personnel. The Defense Finance and Accounting Service (DFAS), which employs about 15,000 of these individuals and had a fiscal year 1998 budget exceeding $1.6 billion, is primarily responsible for managing the accounting and finance operations of one of the nation's largest and most complex entities. Adding to the difficulty of carrying out financial operations in DOD is the continuing effort to downsize DOD.

Because DOD did not have reliable workforce profile information (including formal education, professional work experience, training, and professional certifications) available, we conducted a recent series of studies to obtain information on key financial managers from five DOD organizations.[40] Our surveys covered over 1,400 financial

[40] Financial Management: Profile of DOD Comptroller/CFO Financial Managers (GAO/AIMD-97-97, June 27, 1997); Financial Management: Profile of Air Force Financial

managers identified by DOD and military service officials as being their key financial managers. They often served as (1) comptrollers, deputy comptrollers, or budget officers at DOD and military service headquarters or field activities and (2) managers of accounting or finance operations at the DFAS.

Over half (53 percent) of the key DOD financial managers who responded to our surveys had received no financial or accounting-related training during 1995 and 1996. One in five respondents had received no training at all during that time. In contrast, many state government and private sector organizations we surveyed placed a strong emphasis on training as a means of upgrading workforce knowledge of current financial management, accounting, and reporting requirements.[41] It was also noteworthy that some organizations set internal training requirements for their personnel, while others stressed–and sometimes required–professional certifications in their hiring and promotion decisions–a vehicle which would help ensure that personnel holding such certificates kept abreast of emerging financial management developments.

In October 1997, based on its audit of the department's support operations that are intended to operate on a business-like basis, the DOD Inspector General reported[42] continuing pervasive weaknesses in the personnel area, including incomplete or no training, insufficient management oversight, and an inability to respond to a rapidly changing accounting environment. The Inspector General also pointed out the critical linkage between training and the successful introduction and use of new accounting systems. In addition, the DOD Inspector General's report documented a widespread failure of accounting personnel to understand basic accounting theories and principles that support transaction entries.

DOD leadership has acknowledged that it needs to improve the capabilities of its financial managers, and DFAS is developing a program intended to identify the kinds of skills and developmental activities needed to improve the competencies of financial personnel. In addition, officials with each of the military services told us that they have implemented or are planning a number of programs to enhance the skills and competencies of their

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Managers (GAO/AIMD-98-4, November 28, 1997); Financial Management: Profile of Army Financial Managers (GAO/AIMD-98-58, February 25, 1998); and Financial Management: Profile of Navy and Marine Corps Financial Managers (GAO/AIMD-98-86, April 15, 1998). We are finalizing our audit work on the profile of DFAS financial managers.

[41] Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1998).

[42] A Status Report on the Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund for FY 1996, Audit Report of the Office of the Inspector General, Department of Defense (Report No. 98-002, October 3, 1997).

respective financial managers. However, DOD could enhance its plans to improve the professional skills of its financial managers by taking actions to ensure that (1) all critical competencies are addressed and applied, not just to DFAS, but to all DOD financial personnel, (2) financial personnel receive a minimum amount of annual financial management technical training, and (3) a specific curriculum to support the competencies is developed.

Developing Integrated Financial Management Systems

In our recent report, we stated that the U.S. government has ineffective internal controls due in part to poorly designed financial systems. In addition, we noted that widespread computer control weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse and exposing agencies' computer systems to exploitation by outside intruders as well as authorized users with malicious intent. Nowhere in the federal government are financial systems design and computer control weaknesses more challenging and more serious than in DOD. Furthermore, DOD's approach to dealing with the Year 2000 issue is seriously hampering DOD's chances of successfully meeting the Year 2000 deadline for mission critical systems.

Financial Systems Design

DOD has a vast number of financial management systems. In 1995, DOD had identified and reported on 249 financial management systems in its annual financial systems inventory to OMB. By 1996, that number had declined to 217 financial systems. In the latest report for 1997, DOD indicated a continued decline to 156 financial systems. DOD's performance plan has a long-term goal of reducing the number of finance systems to 9 and, by fiscal year 2003, of reducing the number of accounting systems to no more than 23.

However, DOD does not identify and report on the total number of financial management systems it uses. Specifically, as we reported in January 1997,[43] DOD excluded major financial management systems because they are generally not within the CFO (Comptroller) organization such as acquisition, logistics, and personnel systems. In fact, the Army's (CBSX) and the Air Force's (REMIS) systems which provide information for financial reporting on a large portion of DOD's fiscal year 1997 $635.5 billion in military equipment, are not included in those counts.

A comprehensive inventory of systems used to record, accumulate, classify, and report on DOD's financial management information is a critical step if DOD is to (1) effectively manage its existing systems, (2) prioritize and coordinate efforts to correct longstanding

[43]Financial Management: Comments on DFAS' Draft Federal Accounting Standards and Requirements (GAO/AIMD-97-108R, June 16, 1997).

financial systems deficiencies, and (3) develop a reliable, integrated financial management system. Army and Air Force officials have indicated that they are in the process of identifying the "critical" systems that provide information to the finance and accounting systems owned and operated by DOD's accounting organization–the Defense Finance and Accounting Service.

In addition to not having a complete inventory of its financial management systems, DOD has not documented how it conducts its financial management operations now and plans to in the future. A concept of operations is needed to provide the foundation upon which the rest of the systems planning process is built. A concept of operations is a particularly critical step at DOD because of the organizational complexity of its financial management activities. According to the DFAS September 1996 Chief Financial Officer Financial Management 5-Year Plan, it is estimated that the DOD financial community is reliant on data captured by other functional areas, such as logistics and acquisition, for about 80 percent of the data used in its processes. Without careful planning that includes these other communities, system development efforts are likely to fail to meet DOD's needs. In recognition of this critical planning process, the 1998 Defense Authorization Act requires DOD to submit a concept of operations as part of a biennial financial management improvement plan–the first of which is to be submitted by September 30, 1998.

Without adequate financial management systems, DOD's operations will continue to be burdened with costly, error prone systems that do not provide financial controls to ensure that DOD's assets are safeguarded, its resources appropriately used, or the cost of its activities accurately measured. In fact, the DOD IG recently concluded that DOD's financial systems did not meet the requirements of the Federal Financial Managers Improvement Act of 1996. DOD must, within 120 days of the DOD IG report, submit a remediation plan to OMB to address these deficiencies.

Computer Security

Also, serious concerns exist over the security of the Department's computer systems containing unclassified information. In a 1996 report, which was limited in distribution because of the sensitive nature of the specific findings, we reported serious weaknesses that would allow both hackers and hundreds of thousands of legitimate users with valid access privileges to improperly modify, steal, inappropriately disclose, and destroy sensitive DOD data. That same year, we issued another report which stated that DOD experienced as many as 250,000 hacker attacks on its computer systems in 1995 and that 65 percent of the attacks were successful.[14] Based upon our work performed for fiscal year 1997, these vulnerabilities continue to exist. Specifically, computer controls do not provide adequate protection of significant financial applications involving personnel,

[14]Information Security: Computer Attacks at Department of Defense Pose Increasing Risks (GAO/AIMD-96-84, May 22, 1996).

payroll, disbursements, and inventory information maintained in DOD's computer systems. While DOD has corrected some weaknesses underlying our recommendations from prior reports–thereby improving controls–responses to the recommendations remain incomplete. DOD has announced its intention to develop and implement an integrated, comprehensive information assurance program by August 1998.

Year 2000

DOD relies on computer systems for virtually all aspects of its operations, including strategic and tactical operations, weaponry, intelligence, and security. This reliance extends to its business operations that support the Department including financial management. Most of Defense's automated information systems are vulnerable to the Year 2000 problems, which is rooted in the way dates are recorded, computed, and transmitted in these systems.[45] Failure to successfully address the Year 2000 problem in time could severely degrade or disrupt any of these operations.

DOD faces a formidable task in providing assurance that its thousands of systems will be compliant and that the data exchanged among these systems will be accurate. At your request, we have issued a number of reports on the Year 2000 activities of several DOD components, and our comprehensive report will be issued later this month. We are concerned that the Department has not made adequate progress in addressing Year 2000 issues. While DOD has taken many positive steps to increase awareness and promote information sharing, it lacks key management and oversight controls to enforce good management practices, direct resources, and establish a good picture of overall progress in fixing key systems. As a result, the Department has increased its risk that errors will be propagated from one organization's systems to another's, that all system interfaces will not be thoroughly tested, and that all components will not be prepared to carry on essential business and mission operations in the event of system failures.

FUTURE PROSPECTS

DOD has a number of financial management reform efforts planned or underway. In our recent report on the first-ever set of consolidated financial statements of the U.S. government, we noted that DOD had stated that it planned to complete a new accounting systems architecture, review its inventory accounting processes, and develop a departmentwide property accounting system. Also, OMB has recognized that resolving DOD's financial management difficulties is critical to the development of auditable

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[45]For the past several decades, DOD systems have typically used two digits to represent the year–such as 97 representing 1997–in order to conserve electronic data storage space. With this format, the computer cannot distinguish the year 2000 from the year 1900. Any uncorrected system using dates to compute or generate data will produce erroneous data or in some cases completely fail.

consolidated U.S. government financial statements. As part of the President's Budget of the United States Government, Fiscal Year 1999, OMB identified, as one of its Priority Management Objectives, development of "a plan with specific milestones to obtain an unqualified audit opinion on Defense's financial statement." OMB's continuing strong oversight and support of DOD's efforts to put together and implement a well thought out, comprehensive plan for addressing DOD's many, serious financial management challenges is extremely important.

For our part, we will continue to work with DOD and OMB, as well as with the DOD Inspector General and each of the military service audit agencies, in further defining and identifying solutions for the many difficult financial management challenges the Department faces. We also plan to follow up on DOD's efforts to implement the numerous recommendations we have already made. For example, we have issued a series of reports on the factors to be considered and the data that must be available to meet accounting standards for Defense's environmental and disposal liabilities. Going forward, we plan to further evaluate Defense's property and logistical systems to recommend additional corrective actions to address weaknesses in accounting for major asset categories on the financial statements.

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In closing, Mr. Chairman, sustained congressional attention to the governmentwide implementation of financial management reform legislation now in place, such as that provided by this hearing, will be critical to instilling expected accountability in DOD and other agencies across government.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions you or the other members of the Subcommittee may have at this time.

RELATED GAO PRODUCTS

PROPERTY, PLANT, AND EQUIPMENT

Army Logistics Systems: Opportunities to Improve the Accuracy of the Army's Major Equipment Item System (GAO/AIMD-98-17, January 23, 1998).

Financial Management: DOD's Approach to Financial Control Over Property Needs Structure (GAO/AIMD-97-150, September 30, 1997).

Financial Management: Air Force Budget Request Could Be Enhanced with More Complete Aircraft Data (GAO/AIMD-97-137R, August 21, 1997).

Financial Management: Accuracy of Air Force Aircraft and Missile Data Could Be Improved (GAO/AIMD-97-141R, August 15, 1997).

CFO Act Financial Audits: Navy Plant Property Accounting and Reporting Is Unreliable (GAO/AIMD-96-65, July 8, 1996).

Financial Management: Army Lacks Accountability and Control Over Equipment (GAO/AIMD-93-31, September 30, 1993).

INVENTORY

Department of Defense In-Transit Inventory (GAO/NSIAD-98-80R, February 27, 1998).

Financial Reporting: DOD's Fiscal Year 1996 Financial Statements Inventory Reporting Does Not Meet Standards (GAO/AIMD-98-16, December 24, 1997).

Defense Inventory: Inadequate Controls Over Air Force Suspended Stocks (GAO/NSIAD-98-29, December 22, 1997).

Defense Logistics: Much of the Inventory Exceeds Current Needs (GAO/NSIAD-97-71, February 28, 1997).

Defense Inventory: Spare and Repair Parts Inventory Costs Can Be Reduced (GAO/NSIAD-97-47, January 17, 1997).

Defense Ammunition: Significant Problems Left Unattended Will Get Worse (GAO/NSIAD-96-129, June 21, 1996).

ENVIRONMENT

Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).

Financial Management: DOD's Liability for Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997).

Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997).

Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 8, 1997).

DISBURSEMENTS

Financial Management: Seven DOD Initiatives That Affect the Contract Payment Process (GAO/AIMD-98-40, January 30, 1998).

Financial Management: DOD Progress Payment Distribution Procedures (GAO/AIMD-97-107R, June 21, 1997).

Financial Management: The Prompt Payment Act and DOD Problem Disbursements (GAO/AIMD-97-71, May 23, 1997).

Financial Management: Improved Reporting Needed for DOD Problem Disbursements (GAO/AIMD-97-59, May 1, 1997).

DOD Problem Disbursements Contract Modifications Not Properly Recorded in Payment System (GAO/AIMD-97-69R, April 3, 1997).

Financial Management: Improved Management Needed for DOD Disbursement Process Reforms (GAO/AIMD-97-45, March 31, 1997).

DOD Problem Disbursements (GAO/AIMD-97-36R, February 20, 1997).

Navy Anti-Deficiency Act Training (GAO/AIMD-96-53R, April 12, 1996).

Navy Negative Undelivered Orders (GAO/AIMD-96-37R, January 12, 1996).

PERSONNEL

Financial Management: Profile of Navy and Marine Corps Financial Managers (GAO/AIMD-98-86, April 15, 1998).

Financial Management: Profile of Army Financial Managers (GAO/AIMD-98-58, February 25, 1998).

Financial Management: Profile of Financial Personnel in Large Private Sector Corporations and State Governments (GAO/AIMD-98-34, January 2, 1998).

Financial Management: Profile of Air Force Financial Managers (GAO/AIMD-98-4, November 28, 1997).

Financial Management: Outsourcing Finance and Accounting (GAO/AIMD/NSIAD-98-43, October 17, 1997).

Financial Management: Profile of DOD Comptroller/CFO Financial Managers (GAO/AIMD-97-97, June 27, 1997).

Financial Management: Opportunities to Improve Experience and Training of Key Navy Comptrollers (GAO/AIMD-97-58, May 5, 1997).

Financial Management: An Overview of Finance and Accounting Activities in DOD (GAO/AIMD/NSIAD-61, February 19, 1997).

DFAS Hiring Opportunities (GAO/AIMD-96-916R, July 18, 1996).

SYSTEMS

Financial Management: Comments on DFAS's Draft Federal Accounting Standards and Requirements (GAO/AIMD-97-108R, June 13, 1997).

Financial Management: DOD Inventory of Financial Management Systems is Incomplete (GAO/AIMD-97-29, January 31, 1997).

DOD Accounting Systems: Efforts to Improve System for Navy Need Structure (GAO/AIMD-96-99, September 30, 1996).

Information Security: Computer Attacks at Department of Defense Pose Increasing Risks (GAO/AIMD-96-84, May 22, 1996).

OTHER

Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies (GAO/AIMD-98-56, March 16, 1998).

Financial Management: Issues To Be Considered by DOD in Developing Guidance for Disclosing Deferred Maintenance on Ships (GAO/AIMD-98-46, February 6, 1998).

Financial Management: Issues to Be Considered by DOD in Developing Guidance for Disclosing Deferred Maintenance on Aircraft (GAO/AIMD-98-25, December 30, 1997).

Financial Management: DOD Needs to Expedite Plans to Implement Deferred Maintenance Accounting Standard (GAO/AIMD-97-159R, September 30, 1997).

DOD High-Risk Areas: Eliminating Underlying Causes Will Avoid Billions of Dollars in Waste (GAO/T-AIMD/NSIAD-143, May 1, 1997).

High Risk Area: Actions Needed to Solve Pressing Management Problems (GAO/T-AIMD/GGD-97-60, March 5, 1997).

High-Risk Series: Benefits to Be Gained by Continued Emphasis on Addressing High-Risk Areas (GAO/T-AIMD-97-54, March 4, 1997).

High Risk Area: Update & Progress & Remaining Challenges (GAO/T-HR-97-22, February 13, 1997).

High-Risk Series: Defense Inventory Management (GAO/HR-97-5, February 1997).

High-Risk Series: Defense Financial Management (GAO/HR-97-3, February 1997).

Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996).

CFO Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports (GAO/AIMD-96-7, March 27, 1996).

DFAS-Kansas City Financial Reporting (GAO/AIMD-96-34R, January 12, 1996).

High-Risk Series: An Overview (GAO/HR-95-1, February 1995).

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Mr. HORN. Let me start out with just a simple fact. When we held this hearing several years ago, I would swear on 20 Bibles that I was told there were 49 different accounting systems in the Department of Defense. When I mentioned this the other day to the representatives in the General Accounting Office, I was told there were several hundred accounting systems.

I read Inspector General Hill's statement on page 11. She says the Department of Defense's long-run plan is to reduce accounting systems and cut 82 down to 15. Mr. Toye, who will be our second panel witness, on page 8 says, they will work to eliminate 100 accounting systems by 2003 so there will be no more than 23.

Does anybody have the magic number of how many accounting systems float around that big building and its vast empire across the world?

Ms. HILL. Mr. Chairman, I think that the figure we cite on page 11 is the one for the Working Capital Funds, so it's a subset of the larger figure.

Mr. HORN. Just the working capital?

Ms. HILL. Right. So it is a subset of the accounting systems for all. That particular number is for working capital funds.

Mr. HORN. But can you give a decent guess as to how many accounting systems the Defense funds confront?

Ms. HILL. 122, I think.

Mr. HORN. What?

Ms. HILL. 122.

Mr. HORN. 122.

Ms. HILL. It is down considerably, I think, from 197. I think Mr. Toye's statement cites, I could be wrong on this, I think it cites 156. But I think he may be including the accounting and financial systems. Also, some confusion exists as to whether some numbers are just accounting systems.

Mr. HORN. I just want to begin with one of the obstacles here. You have a variety of different accounting systems. Forty-nine made me angry 2 years ago, and they seem to have grown like rabbits, if 122 is accurate. So, obviously, we face problems on modernization and everything else, including integration. I was glad to see they are on the government Federal ledger now. That's a plus.

Mr. DODARO. Mr. Chairman, I think I can clear up the confusion on the 49. When that question was asked a couple years ago, DOD had reported 249 systems at that point; and it has been further consolidating as noted and are at the 122 or 156 now, depending on whether you are counting just the accounting systems or finance systems.

However, a point that we've made is that DOD really does not have a good complete inventory of the financial management systems in the Department, and that's been an impediment in designing an overall systems architecture that can really bring together the feeder information throughout the Department as well as the core financial management systems.

And also the point I'd make is that the standard general ledger issue is that that, basically, was initiated by the Department of Treasury over a decade ago and should have been in place. I'm glad to see the Department has moved in that direction now as well; and that was, though, reinforced by the fact that the Congress passed a statute in 1996, the Federal Financial Management Improvement Act, that made that a legal requirement.

Mr. HORN. Can't the Secretary just mandate that there be one system, or is anybody even working on that in Defense? I'll ask Mr. Toye that, but I'd like to know what your observations are.

Mr. DODARO. There were some efforts to develop a single accounting system based upon a system that the Corps of Engineers had developed for its own operations, but the efforts to promulgate that throughout the Department have been stalled. There really isn't, I don't think, right now a good plan to move toward integrated systems.

Part of the problem, and we've noted this in our testimony, is that the building block for developing integrated systems is a concept of operations with data definitions, data standards, data flows. That concept of operations is not in place and it needs to embrace not only the accounting systems but the feeder systems as well.

The Congress required last year in the Defense appropriation bill that the Department develop a concept of operations and submit it to the Congress this September. So we're hopeful that will be a good starting point for the development of a viable plan to get some long-term systems in place.

I am a little concerned, though, about the imperative urgency of fixing and being compliant with the year 2000 problem. We have some concerns about the Department's progress that they have made, and we'll be submitting a separate report to you soon on that issue.

Mr. HORN. Speaking of plans and your submission, I was very impressed by what the General Accounting Office had to say. You state that the Department of Defense did not report billions of dollars in costs for environmental cleanup and the disposal of various defense assets, including the cost of disposing of nuclear submarines estimated to range from $18 million to $61 million per submarine. That is one of them. That should wake up a few people around here.

The cost of one Nimitz-class nuclear carrier is estimated to be at $807 million. This is now assuming disposal, I take it, and all the nuclear reactors, etc., that are involved with that and how you deal with that type of radiation. $807 million is the average cost, $942 million for the first carrier, and then such a bargain, with the cost per ship coming down to $500 million per Nimitz carrier. The total projected cost to clean up and dispose of the Nimitz class, all Nimitz carriers in the fleet, is roughly $5 billion to $10 billion.

Now, we also have the cost to dispose of aircraft, including up to $105,000 per aircraft for demilitarization and up to $123,000 per aircraft for removal of hazardous materials. And, of course, everybody wants a new aircraft line every few years. The only thing that has survived around here for 30 or 40 years I think is the C–130. The cost to dispose of aircraft includes up to $105,000, as I said, for demilitarization, and $123,000 for the hazardous materials.

Well, we move now from the Air Force and the Navy, and we look at the Army. Ammunition disposal for the Army is estimated at $1.3 billion to $2.1 billion. Then we look at training ranges, which everybody has. The problem of all the stuff that's been shot across that range for maybe a century, in some cases, or two centuries to clean up the unexploded ordnance. That estimate is roughly $20 billion.

The cost to clean up chemical weapons, for example at the Doug White Proving Ground. I noticed the other day they are trying to ship some of the hazardous materials out of that part of Utah. The reported cost of $10.6 billion is understated, says the General Accounting Office, by $8.5 billion.

What have you done to work with the Department of Defense to get these costs recorded and reported?

Mr. DODARO. I'm going to ask Ms. Jacobson to elaborate on that issue, Mr. Chairman. But this issue—and, to Lisa's credit—we have been working very proactively with the Department to issue a series of reports outlining the factors that need to be considered in arriving at these appropriate liabilities. We've been working very closely with Ms. Hill and Mr. Lieberman in auditing the figures, and we've complemented that by issuing these in-depth reports that you're citing in there are the result of our efforts.

Lisa.

Mr. HORN. Ms. Jacobson, you are the Director of Defense Audits. How long have you been doing that?

Ms. JACOBSON. About 2 years now.

I'd just add that we have been out in the field trying to identify the kinds of documentation that exists to estimate these liabilities. We've issued four reports, one on ships, ammo, missiles, and aircraft; and in each of those we found that there is information available that they can use to either have estimates on certain weapon systems or those estimates and the methodology that they used in developing those, to develop estimates for the weapon systems that they don't currently have estimates. So there is available information, and they should be able to implement it.

The reports we issued indicated that they should have made that effort for 1997, and that the estimates should have been included in DOD's liability. The Department indicated that it didn't have adequate time to develop a policy DOD-wide to do that.

Mr. HORN. The environmental costs are usually the last thing anybody wants to project or deal with. Now, have you found the Department of Defense is willing to put real analysis into this and give us a real figure? I think a lot of these are probably out of a cloud, but I'm used to that.

And my second question would be, is there any interest on the part of the authorization committees and the appropriations subcommittees in both bodies?

Ms. JACOBSON. As Gene stated, the authorization committees have in the past required certain estimates.

For ammo, for example, one of the reasons that we know information is available is because the authorization bills have previously asked the Department to estimate that. The estimate now is a little bit old, but they had developed a methodology for doing that.

For all new weapons systems, there is an existing requirement that these costs be considered in developing those weapons systems and in proposing to Congress the cost of the weapons system, that the weapon system would include not just the acquisition but the full life-cycle cost, including the disposal. We are, in fact, talking about more than just the environmental liability. There are other costs associated with disposing of these, and we're talking about the full disposal liability.

Mr. DODARO. Also, Mr. Chairman, on the issue of the reliability of the estimates, that's really the value of the financial audit process. That not only will DOD have to come up with those estimates, and we're trying to work with them and with the Inspector General's office so that they can be auditable, but we can provide ultimately some assurance to the Congress that the estimating process is complete, reasonable and that the costs can be relied upon in making resource determinations. Also, there will be disclosure of when the environmental cost would come due on a time line basis so that it would help better inform the budget decisions that need to be made.

Right now, if you don't have that information, you're largely just guesstimating about what your costs are going to be down the road.

Mr. HORN. One last question on this, then I will yield to the gentleman from Ohio.

Mr. Warren.

Mr. WARREN. If I could just add, the House National Security Committee is very interested in this area and held hearings last year as part of their reform package for the Department of Defense. They are very cognizant that, ultimately, when these liabilities come due, they are going to be paid out of one of their accounts, principally operations and maintenance; and they are looking for ways to reduce these costs from a front-end standpoint, as Ms. Jacobson pointed out. So there is a very good understanding that these decisions that are made up front will cost us dollars in the future and that we need to act as wisely as we can to reduce them as early as we can in programs.

Mr. HORN. I would be curious as to whether the General Accounting Office and the Inspector General have done any analysis of the office and the decisions in the Department of Defense that relate to the environmental costs on base closures. Have we done some studies on that, and what kind of estimates have we found there? My impression is that not much is happening in terms of actual cleanup.

I mean, some nice studies are being done, but I'd be curious what kind of cleanup is going on in terms of these bases, which were often given by a city or a county or a State to the military at the time of the First World War, Second World War, or Korea. And they said, oh, just pay us a dollar, you know, patriotism; and now to get it back so they can either put it into industrial use or for schools or whatever, maybe you can brownfield it and hope that nobody gets hurt. If it is a school or a neighborhood, you have got a serious problem. What is that adding to the environmental costs?

Mr. WARREN. We are, in fact, looking at that. Right now, the number stands at about $7.2 billion that has been appropriated; and a good portion of that has, in fact, been obligated for the cleanup of closing bases.

Mr. HORN. It has been obligated?

Mr. WARREN. A good portion of it, yes, sir.

Mr. HORN. Well, what is that? Good is half?

Mr. WARREN. I'm talking 80 to 90 percent. I can provide you the precise percentage for the record.

Mr. HORN. $7.2 billion is the figure.

Mr. WARREN. $7.2, sir, at this point.

Mr. HORN. And 80 percent has been allocated?

Mr. WARREN. I can give the precise percentage.

Mr. HORN. Good. I would like to have it put in the record at this point.

[The information referred to follows:]

Table: Unliquidated Obligations and Unobligated Balances for Environmental Projects Through Fiscal Year 1998 (of December 31, 1997)

Dollars in thousands

BRAC round	Appropriated amount	Unliquidated obligations		Unobligated balance	
		Amount	Percent	Amount	Percent
I	$991,747	$122,508	12.4	$22,755	2.3
II	1,733,407	458,437	26.4	47,411	2.7
III[a]	1,457,218	339,044	23.3	368,266	25.3
III (outyears)[b]	274,850	N/A	N/A	N/A	N/A
IV[a]	802,271	200,623	25.0	321,147	40.0
IV (outyears)[c]	1,992,602	N/A	N/A	N/A	N/A
Total	**$7,252,095**	**$1,120,612**	**15.5**	**$759,579**	**10.5**

[a]Includes $2.1 billion appropriated in September 1997 for fiscal year 1998.

[b]Budgeted amount for fiscal year 1999.

[c]Budgeted amount for fiscal years 1999, 2000, and 2001.

Source: GAO analysis of DOD's budget submissions and financial reports on appropriation status.

Mr. WARREN. But your statement regarding the early phases of those programs, how much money, as in the normal cleanup programs in the active bases, was devoted to studies? We do see a turning of the corner at this point in time, where more funds are starting to move to the actual cleanup of those facilities.

Much of this gets tied up in, as you referenced, to the actual use that's going to be made of that property, once the local reuse authority decides how a particular area is going to be used; and that, in fact, in many cases has held up the actual cleanup decision.

Mr. HORN. Very good.

I yield 15 minutes to the gentleman from Ohio, Mr. Kucinich.

Mr. KUCINICH. Thank you very much, Mr. Chairman; and I want to thank the witnesses for being here today.

As we know, we had the first-ever audit of the Federal Government's books recently completed by the GAO and the Inspectors General working with the administration. It was the largest such audit in the history of this country, and it is important, I think, for the American people to know at the outset, so we can put everything in a context here, that many of our Government's most important agencies have received clean audit opinions, including the IRS, Social Security, and the Bureau of Public Debt, and other agencies are making progress.

Of course, that having been said, it is important that we are here today to review the financial management of the Department of Defense. There is no other area which is more vital to this country than being able to defend this country. It is a charge that is as old as this country. Promoting the common defense is something that is consistent with one of the fundamental purposes of government.

The men and women who work for the Department of Defense both in this country and that are stationed all over the world deserve our support. I think one way in which we can support them is to critically analyze the information which is presented to this committee on the audit reports, as well as the system analysis of the financial management and Department of Defense. Because better financial management, it is clear, could save tens of billions of dollars. And since we are always in great debate in the Congress about the resources of the Federal Government, it's critical that an area of our largest expenditures ought to be more carefully evaluated.

Before I get into my questions, I must say in response to I think it was Ms. Hill's remarks that it is disappointing that the Senior Financial Management Oversight Council has not met in more than a year. Because if we are looking at a problem here which involves hundreds of billions of dollars, you would think that someone would be interested who would have the charge of pursuing some advice. And so, you know, I would hope that this Senior Financial Management Oversight Council is going to either be reactivated or something else put in its place.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Opening Statement -- Rep. Dennis J. Kucinich
Hearing on Department of Defense Financial Management

April 16, 1998

Thank you Mr. Chairman, and welcome to our witnesses. The first-ever audit of the federal government's books was recently completed by the General Accounting Office, and the Inspectors General working with the Administration. It was the largest such audit in history -- a truly monumental effort. Many of our government's most important agencies have received clean audit opinions -- including the IRS, the Social Security Administration and the Bureau of the Public Debt. Other agencies are making good progress and moving toward clean opinions and I believe that this Administration is committed to resolving decades-old problems in financial and asset management.

That being said, it is clear that certain problems remain, particularly at the Department of Defense. This Subcommittee has been active in its oversight of the financial management problems at DoD, which is a good thing because DoD has some pretty serious problems accounting for assets, inventory and equipment. It has also apparently severely underestimated the amount of liability faced from environmental cost. Many of the problems cited by GAO for causing them to issue a disclaimer of opinion on the government-wide audit are directly linked to the Department of Defense.

I want to make clear that my comments are intended as constructive criticism. The Department performs a vital role in protecting our national security interest at home and abroad, and the men and women stationed in Bosnia, Korea, the Middle East and around the world deserve our full support and assistance.

Better financial management by DoD could save tens of billions of dollars -- and that's a conservative estimate. Money needed in the lean budgetary times at the Defense Department and elsewhere. Audit reports on various DoD agencies are a catalogue of horrors. Hundreds of billions in underbillings; 15 percent of inventory records wrong; hundreds of billions in unsupported "adjustments"; close to 10,000 contracts out of balance by more than a billion dollars; hundreds of billions in missing equipment and property.

I am also particularly concerned with the reporting of DoD's environmental liabilities. At $38.3 billion for FY 1997, those liabilities are materially understated -- by hundreds of billions of dollars -- due to the Department's inability, or unwillingness, to estimate the liabilities for major weapons systems and ammunition. This information is vital to making informed procurement decisions. Its unavailability is unacceptable.

The financial management situation at DoD is probably the worst in the federal government and is the product of years of neglect. And I must say I am not encouraged to hear that the Senior Financial Management Oversight Council has not met in more than a year, or discussed compliance with the Chief Financial Officers Act in more than four. Leadership in improving the dismal record of financial management at DoD must come from the top. It is not clear that it is.

Thank you Mr. Chairman.

Ms. HILL. I should add, Congressman, that I am told that the plan is twofold. First, this is part of eliminating councils and streamlining the various councils within the Department. Second, the plan is to take the function of that council and put it under what's called the Defense Management Council, which of course has a broader mandate.

Our position, obviously, is that the finance area has to be emphasized. Whether it be emphasized as much in the Defense Management Council as it was in a separate council, time will tell. But, wherever it is, it needs to be emphasized and appropriate leadership exercised in that area.

Mr. KUCINICH. Thank you.

As I'm reading through these reports from both the Inspector General for the Department of Defense as well as the statement of the Comptroller General's Office, it strikes me that we have the kind of cold accounting prose which is instructive, certainly, but it doesn't really get to some of the underlying questions which I think the public needs some answers on.

So, with that in mind, I'd like to start by asking Mr. Dodaro. In looking at your report about deficiencies related to property, plant and equipment and inventories, I want to quote from it, you talk about an impairment of DOD's ability to know the location and condition of all of its assets, including those used for deployment. This report, basically, says that there are weapons systems or materiel that we don't know where it is. Is that correct?

Mr. DODARO. Basically, what it says is that the Department is not able to generate the type of information that can provide assurance that it knows exactly where everything is located, and there are problems with items in transit. Probably one of the best indications this year was the test that Ms. Hill mentioned that our offices jointly conducted to go to the individual logistical systems that are used to generate and roll up the information across at least at the Army and Air Force.

It has been known, for example, in the past, Congressman, that the Army systems and the Air Force systems that have information on worldwide visibility of the assets—in other words, they are supposed to properly account for all the assets of the Army and the Air Force—had a number of errors in them and could not be relied upon.

So we went down to the individual systems and selected about 1,800 items in the Army, the Air Force and the Navy. Actually, the Army and the Air Force passed their tests, as Ms. Hill noted. But the Navy, which has about approximately half of all the assets in the Department of Defense, failed in 3 of the 11 categories and this had in part to do with uninstalled engines. And not only in the case of the Navy did they fail by one or two, they failed by large margins in two of these three categories. So there are problems.

Mr. KUCINICH. If I may, sir, the concept of pass-fail is interesting from a university standpoint. I know Mr. Horn is a professor, and I've taught at the university level.

Mr. HORN. I grade on an absolute, as you know.

Mr. KUCINICH. I note that, and there are times when it is appropriate to grade on an absolute.

When we're talking about $600-and-some billion of assets, I think that an absolute grade is something that's more instructive than pass-fail. Because the pass-fail method, while for public relations purposes is less painful for the taxpayers, might not really reveal the kind of information that would be instructive.

I would like to quote for a moment, if I may, from this report from Mr. Dodaro because I think it is an important report. And I will allow, as Ms. Hill said, we have had problems for 217 years, as you say, ever since the Department of Defense was created. Let us say that is your disclaimer. But now let us look at the internal workings of the Department.

Quoting from this report, which I just did a moment ago, about not really knowing the location and condition of all assets, the Navy systems failed for 3 of the 11 categories of tested military equipment, active boats, which means that there are some boats I take it that have not been accounted for. Is that correct? OK.

It goes on. It talks about assets which are not reflected in the central system, translated, can't account for Howitzer cannons, M–16 rifles and cargo trucks; a missile launcher for an Avenger weapon system that could not be located. This is a lightweight, high-mobile, surface-to-air missile system. It talks about a million dollars. Findings in the Air Force include over 200 ground launch cruise missiles were identified in the assignment table that were not included in either of the other central system data bases.

Now you go on to say that these missiles were destroyed years ago as part of the treaty with the Soviet Union. But there is still a problem with accounting here. Twenty-five aircraft and eight launched cruise missiles were included in the central system inventory in assignment tables but were not in the possession tables, which to me seems like you do not have them because that is what "possession" means. And on and on.

Mr. Dodaro, what is the quantity of the assets that you would estimate in terms of dollar value which cannot be located? Do we have a dollar value that cannot be accounted for?

Mr. DODARO. Basically, it's not possible to determine that at this point because of the records, as indicated in our testimony and the reports of the Inspector General.

Now, Ms. Hill would be able to answer. But, basically, the audit process has found error rates that have prevented us, and prevented the Department, from accurately reporting total amounts. That's also prevented us from doing a lot of statistical sampling, because you don't have good records to sample from. But it's really not possible to determine exactly, I believe, the specific answer to your question.

The process is intended to assure that what has been reported is accurate; and the records are such that they are either erroneous, documentation is not there to prevent anybody from determining exactly whether the information is correct or not.

Mr. KUCINICH. Most of my constituents own a house and a car. If they came home one day and the car was missing, it would be a big event. The car might be analogous to the budget of the Department of Defense or the materiel of the Department of Defense. It ought to be a big event in this Nation that military equipment cannot be accounted for, because it raises the spector of theft, which you admit is a possibility, of black market sales, of powerful armaments, which we know is a possibility, of the arming of groups around the world which we end up having to fight and they have our own weapons, which we know has happened in the past.

I guess the underlying question here, Mr. Chairman, is this: If the accounting of the Department of Defense, which is different from accounting in other areas because we are talking about weapons systems here, if the accounting of the Department of Defense is so uncertain and in some cases appears to be in shambles and always has been, it really raises some profound questions about the national defense and about how safe we are. I mean, if we do not know where our equipment is, what does that say about logistical support? What does that say about our ability to support troops in the field if they need something? I mean, there are implications here to this.

Mr. DODARO. Exactly, Congressman. In fact, in the Army's case, and we cite this, it is called the system, which is a worldwide asset visibility system. When they were equipping troops in Operation Desert Storm, they found in some cases some of the troops got more equipment than what they needed and some didn't get all the information available.

The issue here is that the Defense Department can provide and properly equip. The question is, is it done in the most efficient manner and can it properly account for everything? And that's where the problems come into play. But it can happen, the type of implications that you're talking about.

Mr. KUCINICH. I would say this, Mr. Chairman: I had the opportunity a few months ago to go to Bosnia and surrounding areas to visit troops in the field and to meet with commanders and generals. I was very impressed with the level of professionalism in our Army, very impressed. And I think it is characteristic of the professionalism which we have in the Armed Services overall. The accounting work, which really is a support service, is something that, while the individual soldiers cannot worry about, does affect their existence out there in the field.

That is why, on the one hand, you know, the Department of Defense cannot be like the weather, where everybody complains about it but nobody does anything about it or cannot do anything about it. Because we are talking about a tremendous amount of resources dedicated in this country for defense. Add the cost of health and education and some other things. There are those of us in the Congress who have been debating this issue and the allocation of resources for a long time, and reports like this do not give us any comfort.

There are not any real answers, in effect. You are trying to clean up accounting. You are trying to locate things. You are trying to do better. But I am just wondering, if your accounting is already in shambles—we already know that the year 2000 is going to bring a whole new set of challenges for the Department of Defense. It raises questions as to why you should not just, you know, scrap everything you have and start over. Because it is not too far away from where you are right now, where you do not really know.

We have a system of checks and balances here. We are helping to write the checks in the Congress and the DOD does not know what the balance is. So this is an eye-opener, Mr. Chairman, to have a chance to look through this. And I commend the Chair for calling this hearing because the people of this country ought to know that while we do have a professional Army, we perhaps need an army of accountants to support their work in the field.

Thank you.

Mr. DODARO. Congressman Kucinich, let me just add on that. The Inspector General's Office and our office have made a lot of specific recommendations that can help in the short term, for example, reconciling local records with the central records. So there are steps that can be taken to make some headway in improving the integrity of the data, and we're making recommendations to try to bring that about. So I just wanted to make that point.

Mr. KUCINICH. I have confidence in the people that are here, that you want to make it better. You have had the first-ever audit, and it seems like many other areas of the Government are working better, and it is wonderful.

I feel that this is so big that it could cause us to just say, well, you know, and treat it casually. I look at this report and, if I was not seated in a stable chair, I would probably fall over because of the lack of accountability for hundreds of billions of dollars. So I can tell you I would rather be on this side of the mic than the side that you are on, and I am glad to be here with the Chair so we can try to find ways of improving accountability.

Thank you.

Mr. HORN. Well, I thank the gentleman and yield myself 15 minutes now.

Two years ago, when we found out the Department of Defense had $25 billion worth of something that they could not quite tie down, I said, "Well, what do you think happened to it?" The answer was, "Well, we don't think anybody stole it. We just can't find it." We will have the Defense witness who has been working on this for 2 years, obviously, before us.

But is it your observation that they have pursued this matter seriously? As far as the Inspector General's review and the General Accounting Office's review, has Defense taken this as a serious matter?

Because, as I listened to the fact that some units had more than their authorized supply, going through my mind was, boy, there was a good master sergeant in that unit that made sure his people or her people were taken care of should they be going into combat. And they might well have been swapping stuff all over the world, who knows, and fudging up the inventory book, but a lot of them were doing it to make sure they had enough firepower, they had enough logistical power, carrying power, personnel carriers, and so forth.

So what is your reaction? Do you think they took us seriously 2 years ago or do you think they said, oh, well, they will go away sometime?

Mr. DODARO. Mr. Chairman, are you referring to the problems of disbursements of $25 billion?

Mr. HORN. Yes, $25 billion in the Columbus Processing Center, which until now I have not mentioned. The center was spewing checks out all over America to the tune of millions of dollars when the recipients didn't even have a contract with the government.

Mr. DODARO. I am going to ask Ms. Jacobson to give GAO's view.

Ms. JACOBSON. I do think that they have taken it very seriously. There are a tremendous number of efforts, and in some way that may be a little bit of our criticism—that there hasn't been a coordinated effort to deal with it. Every organization that has this issue within DOD has tried to do something within their organization, but those efforts haven't been very well coordinated, so how they have addressed it hasn't necessarily been that efficient.

However, I do think that they have made progress in the area, but the number still stands at $22 billion, and that is because your $25 billion was significantly understated. They were not reporting, and they still do not report, all of the problem disbursements that do exist out there.

Mr. HORN. Is this simply getting together the acquisition papers, the contracts, and the inventory, or what?

Ms. JACOBSON. No, it is a matter of a payment has been made, a check has been written, and now it hasn't been matched in their budgetary or their accounting systems to tell them what they spent it for, precisely what it went to, what budgetary account Congress appropriated the money for that should be charged, and what they bought with it—weapons, inventory, or operational costs.

Mr. HORN. Let me mention two topics, some of which are related, some of which aren't.

First on the related ones, on the environmental impact of some of these base closures. Around April 2, I believe the Washington Post had this story called "A Dangerous American Legacy." Subject: Acres of U.S. military land in Panama are littered with unexploded munitions.

Here we are, we have worked out an agreement with Panama, they are running the canal now. But what gets me is it is a very bad image for the American military to withdraw from an area and not clean it up, and here you have little kids being blown up.

Now, I was irritated 25 years ago at the U.S. Navy when they withdrew from various Pacific islands. They had not done their duty either, and I was then on the Civil Rights Commission and raised a little cain. Later I was on a foundation to try to resolve that problem.

They left a lot of violence out there without even thinking about helping them with public health, and that outrages me as an American citizen, I can tell you.

So I have the Navy fiddling around the Pacific for heaven knows how many years. Decades. We took over the German mandate and what the Japanese had taken over. Now then we have the Army and these stories. In the last 20 years nearly two dozen Panamanians have been killed and many others injured on and near the U.S. military's free practice ranges by explosives that detonated after being stepped on or picked up. Panama's foreign ministry said 4 years ago a member of the U.S. Navy Seals was badly injured during maneuvers when a discarded shell exploded under his feet.

So we have unfriendly fire there, very unfriendly fire. And have we looked at those at all in the Inspector General's office as to what they are doing about that?

Ms. HILL. We haven't looked at that particular story. We have on occasion looked at incidents. The most recent that I recall is that we looked at some problems with the Defense Reutilization and Marketing Service when they were disposing of surplus military equipment. And there were some problems out west, where one of those shells which supposedly had been demilitarized had not been demilitarized. It exploded and there was an injury. And so we did look at that system and whether or not there were adequate controls in making sure that that equipment really was demilitarized before it was, in that case sold to the public or contractors.

And, in fact, there were problems. There were problems with the coding of the demilitarization codes. We issued an audit report and made recommendations, and I know in that instance the Department was quite concerned about that because, in fact, there had been an injury to a non-DOD person, a civilian.

Mr. HORN. Let me move to another example. That is today's Washington Times, "Computer Hackers Could Disable Military." The lead paragraph by Mr. Gertz is, "'Senior Pentagon leaders were stunned by a military exercise showing how easy it is for hackers to cripple U.S. military and civilian computer networks. According to new details of the secret exercise, using software obtained easily from hacker sites on the Internet, a group of National Security Agency officials could have shut down the U.S. electric power grid within days and rendered impotent the command and control elements of the U.S. Pacific Command,' said officials familiar with the war game known as Eligible Receivers."

I love those Pentagon titles. It's marvelous.

"'The attack was actually run in a 2-week period and the results were frightening,' said a defense official involved in the game."

I am curious. Was the Inspector General's office involved in this at all?

Ms. HILL. That particular one, we were not. I will say on that subject that it is a very serious problem. I think DISA, the Defense Information Systems Agency, estimated in 1995 that there were 250,000 attacks annually on DOD systems, and I am told that has increased in the last 2 years. What is very scary about it is that the percent of those that are detected and reported is minuscule, and this is a very serious problem. It has been raised to the forefront, I would say within the last year, on a couple of fronts. Within our shop, our criminal investigators, the Defense Criminal Investigative Service partly for my pushing and also by their own recognition of this as a growing area, not only for Defense but for all agencies, have actually crested a unit of people who are going to be trained in computer intrusion cases. They in fact are working closely with the Defense Information Systems Agency to be there to detect and followup on the criminal side of these cases.

In addition, I think you may know the Justice Department and the FBI is heading up what is called the National Infrastructure Protection Center, which is a recent innovation. It is designed, although the FBI I believe is heading it and the Justice Department plays a heavy role, it is going to have agency reps from many different agencies and there is going to be a substantial contingent from the Department of Defense. Our people are working with that center and they are working closely with the FBI. The whole purpose of setting that center up is to, governmentwide, bring in information on computer intrusions and raise our level of expertise in law enforcement and on the detection and protection aspect, too. So there is a lot of activity right now in that area.

My own view is you can't have too much activity because it is a horribly grave problem, and it is likely to get bigger because the hackers you are talking about, we don't know the extent. It is growing, and the scary thing is that the tools that they use to do this are tools that are now available to millions of people on the Internet, so it is a very real problem.

Mr. HORN. Is the Department building firewalls within, so those internal systems cannot be accessed?

Ms. HILL. Yes. We have done many, many audits and much work on this whole area of information security and technology security, and we have done it on very different systems. We have made recommendations. We made recommendations on firewalls. They are responding to our recommendations, so there is a lot of work going on in that area. That is not to say that the problem is fixed, and I wouldn't want to mislead you and tell you all those systems are secure because there are obviously major problems out there, but I do think the incidents that you cited have gotten people's attention. With the creation of the center and the FBI's involvement, we are working closely with them in trying to get our own act up to speed in our shop.

I can also, on a broader scale, tell you this is an issue for all of the Inspectors General, not just Defense. At the President's Council on Integrity and Efficiency, of which I am Vice Chair, this is an issue that we have talked about. In fact, we just earlier this week had a presentation made by the FBI on their capability, and their wish to work closer with all of the IGs to get this problem managed across government, not just at DOD.

Mr. HORN. Do we know the extent to which outside hackers have fiddled around with the accounting systems in the Pentagon as opposed to different computing systems which are not related to accounting?

Ms. HILL. No, we don't. The best estimates we have are the DISA estimates, which are that there are a huge number of attacks across the board. I don't think that they have narrowed it down to the type of system, but generally speaking it is a very large number of intrusions. It is a very good-sized success rate as far as getting into the systems, and at present there is a very small detection rate and reporting rate, which is crucial if you are going to followup from a prosecution standpoint.

Mr. HORN. In this example where the National Security Agency tried this and was successful, the only group that they used out of several dozen, was the group based in the United States. They did catch that one somehow, but they didn't catch the attacks from overseas or offshore.

Does the General Accounting Office have any views on this?

Mr. DODARO. Yes, Mr. Chairman. In February 1997, we designated computer security across the Federal Government as a high-risk area. In the Department of Defense, we issued two reports in 1996, one on the vulnerabilities to outside hackers. One of the reasons defense is more vulnerable than a lot of other agencies is because it made great use of the Internet. DOD had not developed a comprehensive security program to make sure that they control all and know where all of the Internet access points really are.

We also issued a report that was limited to official use only of problems with authorized users within the Defense Department itself and among its contractors, which is another area of considerable vulnerability. In that report, we identified about 250 specific weaknesses, and this is back in 1996. They have corrected about half of them. We are following up on those areas right now.

But like Ms. Hill's earlier point, the decentralized management structure for computer security has been a problem. Our recommendations have been to have more of a coordinated departmentwide strategy, to train some of the users better, and to have an incident reporting capability so you can monitor it. This capability is now set up, so there is a lot that needs to be done. I agree wholeheartedly with Ms. Hill's assessment that this is a very, very serious problem which needs vigilant attention.

Also, the year 2000 problem has a potential to accentuate these vulnerabilities, because DOD will be making in a compressed time schedule so many changes to its computer systems that I am concerned that the security aspects of those systems concerns are going to be shortchanged because of the pressures to get the software changes in place before the year 2000. So we need to be especially careful over the next couple of years with our computer systems throughout the government and especially in the Defense Department.

Mr. HORN. Well, I appreciate that statement. Let me give you another example, and then we will close this out and I will yield to the gentleman from Ohio.

On March 12, 1997 in the Chicago Tribune this story appeared. Headline: "Wisconsin Man Guilty in Theft of Tank Equipment from Fort McCoy." Lead: "A military surplus dealer was convicted Tuesday of masterminding the biggest theft of fighting equipment ever from a United States base: a $13 million heist from the Wisconsin Army Reserve Camp that included a tank and 17 armored personnel carriers. Leo Anthony Piatz, nicknamed 'Tanker Tony,' was found guilty on all counts of conspiracy, bribery, and conversion of government property."

In brief, crime does not pay, at least with this one.

Prosecutor said Piatz, age 37, of Hudson, used bribes, phony documents, and six accomplices to drive off with at least 153 vehicles from Fort McCoy.

Can't you just see them sort of waving at the gate? What are those MPs for at the gate? Ninety-five miles northwest of Madison, five others charged in the scheme face trial in June. In addition to a Vietnam-era Sheridan tank and the personnel carriers, the stolen vehicles included an airport runway snowblower truck, a crane, and other heavy equipment. They were taken between 1994 and 1996.

I won't go into all of this, but some of it went to museums and some went to ski lodges. My question is, you look at CIA and Ames. A lot of cash was going to him for what he was giving in secrets.

Does anybody do checks on some of the people involved with logistics, inventory, or warehousing? Has anybody looked to see if they are living in a 17-bedroom home somewhere, or what? What is the Pentagon's approach on that one?

Ms. HILL. Well, that case I am very familiar with because—actually that case was done by our Defense Criminal Investigative Service, along with the FBI. It was a joint criminal investigation.

As far as looking—and you are right. As I recall the facts of that case, it was really a bribery. They were basically paying off to get access to that equipment.

Looking at individuals—whether a person is living beyond their means, that sort of thing generally comes into play in the security clearance area. That is an issue that they usually focus on during security clearance background investigations, reinvestigations, that sort of thing.

I do not know offhand what types of clearances these individuals in that case had. It would really depend on the clearance level. If it was a lower-level employee that probably had no access to any classified information, my guess is they probably don't keep a running track of that, other than colleagues that the person works being surprised if they see something odd and that sort of thing. And, of course, we do run the hotline at Defense, and sometimes we do get tips that come through the hotline from people working with individuals who see something suspicious. But the real focused review of a person's financial status comes in the security clearance background checks.

Mr. LIEBERMAN. I might add, Senator McCain has had us looking intensively at the controls in the disposal system for the last 2 years. There is a body of products on that subject.

Essentially this is an area that is extremely difficult to eliminate fraud in. There is always going to be a risk because of its very nature, but I think we have essentially good controls in place.

The problem is getting everyone to comply with the procedures that are in place, and you are going to have some leakage out of the system from time to time. This particular case, I guess, is considered a success story because the culprits were identified, and we do have a lot of criminal investigative activity coming out of the disposal process. There have been quite a few indictments and convictions over the last several years.

Ms. HILL. That is a growing area of activity for DCIS, and mostly it is fraud and diversion of surplus equipment and that sort of thing.

Mr. HORN. Has GAO done any review on this in terms of inventory control, regardless of whether it is at the Pentagon—we can look at GSA, they have huge inventories around the United States—as to whether some of the stuff is just missing?

Mr. WARREN. We have generally looked at theft cases over the years, and I would echo what has already been said on this issue. It is a very difficult issue because the system is dependent—it is highly decentralized first to the local bases and activities, and it is dependent on the set of controls that are in place; and, furthermore, dependent on the group of people that are in fact administering those controls to do the right thing, so it becomes a very difficult process to identify.

We have been most successful in going in and taking a look and doing in essence compliance reviews to find out if that is occurring. Where we become disappointed is typically when we do that type of thing, we find that the set of controls that are in place are not being followed. A good example is in the Marine Corps where last October the property book office that was controlling equipment that was going to the training ranges had properly signed it out and did all of the things that they were supposed to do to provide it to the troops. However, when the folks got to the ranges, instead of expending that material they just kept it and walked off the base with it.

There was a control in place. Somebody was supposed to be checking at the range to make sure that that didn't happen. So you had a breakdown in controls and the material was lost.

The point that I want to go with which I think has been made earlier, is that there has got to be a top-to-bottom commitment of leadership. This is from the civilian to the military chain, to enforce these controls in a highly decentralized system if it is going to work, and there is no substitute for that.

Mr. HORN. Well, do you feel that we have that leadership? Do you feel that things are beginning to happen?

Mr. WARREN. I am most familiar with the Army. The Army had some severe problems several years ago. I think they put in a very effective program to make that happen, and I think it bore some very good results. I am not so sure that is occurring across the other services as well.

Mr. DODARO. The basic tie-in back to the financial audit and the look at controls is that audit focuses on the basic checks and balances. Does the inventory match the records? Do the property books match the central system so you have that type of check and balance in place? And what the Inspector General's office found is that overall checks and balances are not working properly, and then you have the sort of subset of controls at individual locations that we are talking about of a decentralized nature. But until you get that whole control structure operating effectively, you don't have an efficient way to do this year in and year out, and that is the value of the audits.

If you are totally relying on tips from people, you are never going to be able to prevent it. And part of the effort in the financial audit is to identify ways to prevent these things from happening and to provide that sort of discipline year in and year out to have the proper control systems in place and follow them, and I agree with all of the comments that have been made. Typically at DOD, the policies are there. It is the application and the follow-through to ensure that they are being complied with that is really where the breakdown occurs.

Mr. HORN. I remember when we had State auditors, system auditors, and all of the rest in the university system. Our chief auditor had some good advice. He said those people that never take a vacation, have them take a vacation. And it is amazing. He cited numerous examples in another university system in a State that will go nameless, but one of the top officials in the university was siphoning off bails of hay to his ranch; and somebody sat in the desk and said, that is an interesting bill, I wonder what that is about, and they got him. There are a lot of ways to get people here, and I just wonder if you feel that we are proceeding in some logical way to check whether we have had major losses?

Mr. DODARO. Clearly there needs to be more commitment to get the broad checks and balances in place so DOD can pass the test of an audit. Until you do that, you are really not going to know at the highest level that you have the entire system of controls in place.

Mr. HORN. I yield 20 minutes to my colleague. I have gone past my red light so if he has that many questions, go to it.

Mr. KUCINICH. I will say that it would be fine with me to listen to the Chair's questions for another 20 minutes, because I have been getting an education just following your presentation and I am glad to be here on this committee to participate with you.

I want to return to quoting from the report of Mr. Dodaro, because I think that it helps to continue to focus us on the challenge so that we give this the proper gravity, respect the moment of this discussion. Quoting from the report: "As discussed in our recent report on fiscal year 1997, consolidated financial statements of the Federal Government, one of the world's largest holders of physical assets, does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than $1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records."

Quoting further from the report with respect to military equipment accountability and visibility: "DOD, Department of Defense's investment in military weapon systems represents an estimated $635 billion of the Federal Government's total property, plant and equipment, reported at about $1 trillion. Accountability over these critical assets entails knowing for each asset category how many exist, where they are located, and their value. Overall, the auditors found that the Department of Defense's logistical systems could not be relied upon to provide this basic information."

Under the section Inventory Cannot be Verified: "Department of Defense inventory includes ammunition (such as machine gun cartridges, rocket motors, and grenades), consumables (such as clothing, boats, and medical supplies), stockpile materials (such as industrial diamonds, rubber, and tungsten), and repairable items (such as navigational computers, landing gear, and hydraulic pumps). Department of Defense's inability to effectively account for and control its reported $170 billion investment in inventories has been an ongoing area of major concern."

I just wanted to read that for emphasis so that we have an understanding of the parameters of the challenge which is before us. It is also a challenge to maintain the confidence of the American taxpayers, who yesterday celebrated their yearly anniversary encounter with the Internal Revenue Service. Today we talk about how the bulk of their treasury is being used. It does not provide any comfort, I am sure, to taxpayers to know that many serious questions remain about accounting for substantial expenditures.

Mr. Dodaro, earlier we were talking about not being able to locate certain equipment. Have there been any audit findings about equipment that eventually was located, the findings of which are now classified in terms of equipment that found its way into any particular hands that the government isn't talking about?

Mr. DODARO. Let me ask, Dave, do you know?

Mr. WARREN. You mean in terms of items that might have been diverted to——

Mr. KUCINICH. Has the CIA ever been involved in followup in determining audit?

Mr. WARREN. The answer would be yes, but I couldn't go any further in an unclassified——

Mr. KUCINICH. You answered my question by saying yes.

Mr. HORN. If I might check, what I heard the gentleman asking was if there had been a situation such as he described and these people had been caught, was that case then classified.

Now, we didn't say it was in a classified relationship there where CIA, Army Intelligence, whoever was involved, but where somebody was just trying to keep the outcome of that case—which doesn't tell us a thing about any intelligence operation—but were they trying to cover up the fact that we have these problems?

Mr. WARREN. No.

Mr. HORN. I will give you an analogy. University libraries. There are people that steal rare books all the time. The attitude had been 20 years ago, don't ever report it. Well, that is just plain wrong. Once you reported it, you got a lot of help from a lot of people trying to say, "hey, these are your books and they are worth $200,000 or $100,000." But they had sort of this code of silence. And the way that I am listening to the question: Is there anything where you people have exposed something, where this is now classified, so nobody can look at it unless they have a top secret clearance or something?

Mr. WARREN. My answer would be no. The cases that I am familiar with I think were classified for appropriate reasons and reported to the appropriate committees that have jurisdiction in that area.

Mr. KUCINICH. What are the appropriate reasons for classifying as a result of audit findings?

Mr. WARREN. They have national security implications.

Mr. KUCINICH. Let's follow this, Mr. Chairman, and I am grateful for your colloquy, because you have been doing this longer than I have and it is good to have your experience. I just want to follow this.

The audit findings in which the CIA perhaps has been involved in tracking down information subsequently become classified?

Mr. WARREN. In the cases that I am aware of, yes.

Mr. KUCINICH. Yes or no?

Mr. WARREN. Yes, they were classified.

Mr. KUCINICH. And the reason is for national security purposes?

Mr. WARREN. Yes, sir.

Mr. KUCINICH. OK, now we are getting somewhere. So what that means in drawing out the implications—and kind of confirming what Mr. Dodaro answered earlier—that there are instances when weapons or weapon systems—we don't know which because we are talking about something that is classified here—got out of the control of the United States because if the CIA is involved, since their charge is not domestic, it is foreign, and became under the control of some elements not connected with the United States, presumably.

This has foreign policy implications and your work here—it is very important and much appreciated. We have to look to the implications of what we are finding out here. If you have poor accounting systems, it raises questions about logistics and our ability to support the mission of our Armed Services, both domestically and globally.

You have weapons systems—or weapons which have been missing, and you have just said that the CIA was involved. The implications of that would be that certain material from the Department of Defense has fallen into the hands of people who might not necessarily be friendly to the United States of America.

I think this would give all of us a certain amount of pause, and again I respect the fact that you can only say so much because there are some—there is some information classified here.

Mr. Dodaro, do you have other reports available which can trace a weapons system or a major weapon that went from procurement, wasn't received or in possession, and then found its way out of the country? Do you keep a list about these things? Do you track these things?

Mr. DODARO. I do not know the answer to that question. I would have to——

Mr. KUCINICH. Is there anybody who knows the answer to that question?

Ms. HILL. I am not aware of the instances they are referring to so——

Mr. KUCINICH. Is that in your bailiwick to answer that question? Are you qualified to say that you are not aware, based on that question?

Ms. HILL. I am certainly not aware of everything that happens in the Department of Defense.

Mr. KUCINICH. That is established from everyone here, but that is not my point.

Mr. HORN. If I might, I think this is a pertinent time to ask what are the various Inspectors General of the various services doing? Do they primarily handle these cases and is there coordination with your office? Are you aware of their closure on particular cases?

Ms. HILL. We work closely with the service IGs. They have a slightly different mission than we do. They work with us on a number of different issues; for example, whistleblowers' reprisal cases. We keep in contact with them on senior official investigations. We don't keep in contact with them on everything that they do, certainly.

If the Congressman is talking about a criminal investigation, if there was some information that a weapon system had been diverted to a foreign country and that there was a criminal investigation on, our criminal investigative people would be involved with that or the FBI would be.

All I am saying is, I am not aware of any audit reports that became classified where the reason that they were classified was because there had been a diversion of some weapon system that went overseas or out of the country and was lost. That sort of thing.

I don't want to leave the impression that we were aware of such a thing, because I am not.

Mr. LIEBERMAN. We see all audit reports done in Defense, and in the last 10 years I have never seen one that followed that scenario.

Mr. KUCINICH. Are you aware of the CIA doing followup on auditing of——

Mr. LIEBERMAN. No, sir.

Mr. KUCINICH. Mr. Warren said that you are; is that correct?

Mr. WARREN. I thought the question to me was, was I aware of any instances, and my answer was yes.

Mr. KUCINICH. Mr. Warren——

Mr. WARREN. This was through GAO's work.

Mr. KUCINICH. I understand. I don't want to get the bureaucracy pitted against each other here. I am looking for the truth of the matter. You might not be aware, but someone is.

Ms. HILL. I am not saying that, because we are not aware it doesn't exist.

Mr. KUCINICH. Thank you. If someone is aware, you may just not know?

Ms. HILL. That is certainly possible.

Mr. KUCINICH. That doesn't mean that it didn't happen. I just want to establish that for the record because I am particularly concerned to know not only that we have accounting problems in the Department of Defense which could result in weapons being stolen or diverted to a black market, but also I am interested in the foreign policy implications of what happens if weapons are diverted. And since the Central Intelligence Agency must know something about this, they probably would be the ones most appropriately to question about it. And it goes beyond the scope of this particular hearing; however, it comes up in this hearing because we are talking about accounting. So I am——

Mr. WARREN. There are annual summary reports, as I understand from the Defense Investigative Services, dealing with theft of military inventory, and data is available on a regular basis in terms of the number of thefts that have been reported and in fact they are being pursued on an annual basis, so that information, I think, is routinely available.

Mr. LIEBERMAN. Yes; and there is information available on items that ended up in foreign countries. But your specific question went to U.S. intelligence agency involvement?

Mr. KUCINICH. Exactly; because that has a different meaning. That is just about what ends up in different countries. Contractors all over the globe, contractors could hold on to material and never report it, and since you have $90 billion involving contractors and accounting discussions, you know what I am talking about, and I just wanted to make sure that we brought this forward on the public record.

I just have a couple more questions here. To Inspector General Hill, according to your testimony, Department of Defense made a number of very substantial unsupported adjustments in its books, hundreds of billions of dollars worth. Tell us what an adjustment is. What do you mean by adjustment?

Ms. HILL. Well, it means that the figure—in other words, they are matching up accounts. DFAS, the Defense Finance and Accounting Service has several centers throughout the country and they do most of the accounting for the Department. It goes through DFAS, much of it, and they would be trying to reconcile accounts. I think the one example we cited was the Air Force general ledger. The Air Force books, the Air Force accounting, with the accounting that they have on the appropriation accounts. And in order to make those match, they will make adjustments up or down. In other words, an adjustment could be a plus-up or a decrease in the figure.

Some of the figures we give you are large, run in the billions. That is the total figure of the adjustments, plus and minus, that they have made to those accounts over the course of whatever time period we reference.

Mr. LIEBERMAN. What we are trying to show is how poor the flow of information is. There should be minimal changes necessary when the financial statements are put together, but our systems don't talk to each other very well. Therefore you have all of these errors that are corrected, in some cases several times over, back and forth, trying to get the same lines to reconcile properly.

Mr. KUCINICH. Going back to Ms. Hill, you spoke in your testimony about the Defense Finance Accounting Services?

Ms. HILL. Right.

Mr. KUCINICH. You have supporting documentation for adjustments totaling about $217 billion. What does that mean?

Ms. HILL. When we went in and looked at the adjustments that were made, they were making adjustments because the figures weren't matching, and that indicates poor information. We reviewed the adjustments and what was the justification for the adjustment, why did they make it. We couldn't find supporting documentation to convince us that it was a valid adjustment; in other words, to support the fact that they either plussed it up or decreased it. It all goes back to poor information. They have very, very poor information.

Mr. KUCINICH. I understand that.

Now, I think you mentioned that a third of your staff will be engaged in CFO Act audits by the year 2002.

Ms. HILL. Right.

Mr. KUCINICH. Could you give us a summary of your budget and the downsizing trend your office is facing?

Ms. HILL. The OIG of Defense covers more than audits. We also have criminal investigations, administrative investigations, and policy responsibilities on criminal investigations and audits. We have been undergoing a program budget reduction. We will be decreasing by about 37 percent in personnel from the year 1995 to 2001.

Right now, I think we are at about 1,270 and we will end up with about 1,059 people in the year 2001. Regarding the predictions on the CFO, obviously as we downsize, we don't want to give up the quality of what we do, so we are instead going to be doing less of what we do. We are trying to keep to our core functions.

When we look at what we have to cut, we cannot cut our CFO work because it is statutorily mandated. That is going to take a bigger chunk of resources, which is going to leave us with less resources to do risk assessments and many other things: management requests, congressional requests, et cetera. So it is going to have an impact on our ability to cover some other high-risk areas in the Department.

Mr. KUCINICH. Years ago, I remember looking at cartoon pictures which would ask you to identify 10 things wrong with this picture.

Today you presented us with a picture of massive inability of the Department of Defense to adequately account for hundreds of billions of dollars in assets. We learned of hackers who—in 1995 I believe it was over 250,000 passes were made at the computer system, some of which have the ability to rearrange data. We are looking at the year 2000 and the implications of the impact on the computer systems and the information in those systems if the systems were perfect, which they are not.

On top of that, Mr. Chairman, we are now hearing testimony that one of the agencies charged with the authority to let the American people know what is going on is facing a reduction in their budget. I think that based on the testimony we have had here today, such a reduction is not only not warranted but it is against the interest of the American taxpayers, because if we know that we are right on the threshold of breaking through and finally attacking what has been a centuries-old mess of Department of Defense accounting, it seems the last thing that we would be doing is to attack one of the offices which can protect the resources of the American taxpayers.

So that having been said, I think that it is appropriate for members of this committee to take that up with the administration as well as with the relevant congressional authorizing committees to discuss this information which we have had brought to us today.

I thank you very much for your indulgence, Mr. Chairman. I thank the witnesses, too.

Mr. HORN. I thank you. It was a very useful series of questions. I didn't get into a lot of nitty-gritty, Mr. Dodaro, that is in your report, but it is rather fascinating in terms of the duplicate records for the helicopters, the various missiles which it says here on page 10 of the draft, "Over 200 ground-launched cruise missiles were identified in the assignment table that were not included in either of the other central system data bases. According to the system program office, these missiles were destroyed years ago as part of the treaty with the Soviet Union."

You are saying until you called their attention to it, they hadn't figured out where they were or if they even existed and then they tracked it down? What was the story on that?

Ms. JACOBSON. What we did was a computer match of those three tables which are in that system, and one of those tables was inaccurate.

Now, there are 1,700 users of that system, and which tables and how they use them, we are not clear. But we felt that the information should be consistent and accurate in all three of them because somebody may be looking to that particular table to identify where these things were and not know that they no longer existed. It is highly unlikely, I would say in this case, that they didn't know that those had been destroyed, but it was just an example of one of the items that we found.

Mr. DODARO. Basically the answer is that the data in the systems is inaccurate, and until we do these types of analysis it is not fixed in the records. The same thing is true in some of those categories where we found the Navy did not find things; things were disposed of years earlier but were still carried on the books as available assets. And there are other items that the Inspector General and the audit services have found that are in existence, that are not on the books, so you have the problem in both directions.

Mr. HORN. You cited the example of a unit that had more equipment than they thought they had, based on analysis of what was in the system.

Now, were there any of those units that were ever sent into combat or any type of duty where they suddenly realized they didn't have X number of tanks that the system said it had?

Mr. DODARO. I was quoting a "lessons learned" report done by the Army after the operation Desert Storm exercise, so they were looking at that and developing a set of observations based upon how that deployment worked. So that was actually an analysis, after the fact, of how troops were supported.

Ms. JACOBSON. I would just add that is not the basis—this visibility system is not used for that particular purpose of deployment. It is used to support deployed units and to provide them with the supplies that they need, but they have other readiness factors and systems that they use to determine whether a unit has its equipment and is ready for deployment. It wouldn't be this system, just so people don't get alarmed.

Mr. HORN. That is what I am curious about. Did they get into the Gulf and not have the proper equipment that all the charts said they did have?

Ms. JACOBSON. This "lessons learned" report is really going in the opposite direction; that, because they couldn't rely on the system to tell them exactly what they had, they were pushing a lot more supplies to the units than perhaps they needed, and that was to the detriment of the units that remained behind. There is only a limited amount of resources, and with all of it going to the theater, the units that were here were not getting what they needed to keep them fully up to——

Mr. HORN. The ready.

Ms. JACOBSON. Yes.

Mr. HORN. Does my colleague have any further questions?

Mr. KUCINICH. No.

Mr. HORN. I think it is about time we brought in the representatives from the Department of Defense. So I thank you all, and maybe one or two of your staff should stay just in case we have a question.

Ms. HILL. Thank you, Mr. Chairman.

Mr. HORN. So if Mr. Toye will come forward.

Nelson Toye is the Deputy Chief Financial Officer of the Department of Defense and he will be accompanied by Eleanor Spector, Director of Defense Procurement.

[Witnesses sworn.]

Mr. HORN. The clerk will note that both witnesses took the oath and affirmed it.

STATEMENT OF NELSON TOYE, DEPUTY CHIEF FINANCIAL OFFICER, DEPARTMENT OF DEFENSE, ACCOMPANIED BY ELEANOR SPECTOR, DIRECTOR OF DEFENSE PROCUREMENT

Mr. HORN. Mr. Toye and Ms. Spector, I assume that you have been listening to the discussion.

Mr. TOYE. Yes, sir.

Mr. HORN. Let's start with a question and then we will have you go through your statement. Is there anything that comes to mind of what you heard this morning that you would like to straighten out right now?

Mr. TOYE. Yes, sir. Mr. Chairman, I have heard a lot this morning and there has been a lot in recent GAO and IG reports about DOD's financial management. And I am not going to say that our financial management records are as clean as we would like them to be, however, I think it is important to understand some of the details, because without understanding the details, the characterization of the problems is seen in a much different light.

For example, when we talk about billions of dollars of adjustments in financial records, in most instances what we are talking about is property records that are not maintained in DOD's financial management systems; instead, they are maintained in logistic systems. So when it comes time to do financial statements, these adjustments are merely the entering of information into the financial systems in order to enable them to produce the financial statements.

For example, real property at Fort Hood may not be in DOD's financial records. Instead, they are in logistics records. So that information would need to be entered into the financial system at the end of the year to do the financial statements.

Those adjustments can involve hundreds of millions and in some instances billions of dollars, and so we need to properly characterize many of those so-called adjustments. Additionally, some of the other examples that were given this morning with regard to property or inventory items are really a reflection of the paperwork not keeping pace in a number of instances with the physical movement of property from one location to another.

This is not to imply that the Department does not have good information, does not know where its property and its equipment is located. It does mean, however, in some instances, that our property records are simply not up to date. In part, this is similar to an example that I think was given this morning about an automobile. Somebody asked you about your automobile and it is sitting out in the driveway and you know it is yours and you've had it for 10 years and it has your license plate on it, but the auditors come in and they ask you to produce a registration and you cannot produce that registration. Maybe it is upstairs, maybe it has fallen out of your wallet, and you cannot produce the registration so you cannot convince the auditors that that automobile is yours. But that does not mean that you've lost control of the automobile; what it means is that there is a documentation problem that needs to be resolved, and that is the case with many of the property issues that have been cited in recent audit reports.

Mr. HORN. OK. Do you want to make your statement, give us the overall view of it?

Mr. TOYE. Yes, Mr. Chairman, if I may, I have a very short statement that I would like to make.

First of all, I would like to say that it is a pleasure to appear here today to discuss with this committee DOD's financial management operations.

Mr. HORN. You recall that you are under oath when you say that. [Laughter.]

Mr. TOYE. Thank you, Mr. Chairman.

Mr. Chairman, the Department is in the process of undertaking the most comprehensive reform of financial management systems and practices in the Department's history. Progress has been substantial, but much more work lies ahead. In 1994 the Department's financial management operations were conducted at over 330 field installations or sites. Since then, the Department has consolidated its financial operations into 5 centers and 21 operating locations.

In the process, the Department has been able to eliminate redundancy, eliminate unnecessary management layers, facilitate standardization of information, improve the accuracy and timeliness of its financial operations, increase productivity, and realize considerable savings.

The Department also has eliminated and will continue to eliminate, outdated financial management systems. The Department currently has 156 finance and accounting systems compared to 324 such systems in 1991. The long-term goal is to reduce the number of DOD finance and accounting systems to about 32.

Simultaneously, the Department also has been improving the remaining systems to make them capable of providing more accurate and timely financial management information that will better permit the Department to produce auditable financial statements. However, during the past few years, additional accounting requirements have been imposed on all Federal agencies, including the Department of Defense. This is equivalent to moving the goal line during the course of the game.

These new requirements necessitate even more substantial changes to the Department's financial management operations, processes, and systems. The Department is implementing the required changes, but progress is slow. In part, this is because of the size and the diversity of the Department of Defense. There is no other organization in the Nation, perhaps in the world, which is as large and diverse as the Department of Defense.

The Department operates in excess of 100,000 weapon system platforms. It maintains over 500 bases in approximately 150 countries and territories throughout the world. It employs over 2 million active duty and Reserve and Guard military personnel, as well as over 700,000 civilian employees. The size of the Department's three major components, the Army, the Navy, and the Air Force, dwarfs the largest organization in the private sector as well as most other Federal agencies.

In addition to the Department's direct warfighting capabilities, the Department also maintains and operates many related support functions. These include a large number of hospitals and health care facilities, a number of shipyards and other depot maintenance facilities, numerous research and development laboratories, extensive transportation capabilities, as well as numerous other functions. And of course the Department's direct military capabilities as well as the many related functions, support functions, have to be maintained in top operating condition 24 hours a day, 365 days a year in a global environment.

What is most important to the Department is the ability to respond and, when necessary, to respond quickly anywhere in the world with sufficient force to counter events which may threaten the Nation's security.

Mr. Chairman, I am an accountant. I have spent much of my career working to improve the Department's financial management processes. Sound financial management principles are important to me, but I recognize and I believe that others recognize also that the primary mission of the Department of Defense is to be able to respond with sufficient force in sufficient time to protect the Nation's interest. The Department performs that mission very well.

The ability to prepare sound financial statements is also important, but it is secondary to protecting the security of the Nation. I hope that this committee and the American public will weigh the relative importance of a strong military force that can be deployed rapidly to destinations throughout the world against the ability of the Department to provide receipts for property that may have been purchased 20, 30, 40, or 50 or more years ago.

Before I conclude my opening statement, let me begin by countering what I believe to be an inaccurate impression that might have been created during testimony earlier this morning.

Many of the examples cited by the GAO reflect paper work that might not always keep pace with the physical movement of property, as I mentioned earlier. Despite the impression that may have been created, the Department does have control of its assets and is prepared to apply those assets when and where needed, and the Department does have the information that it needs to make sound business decisions. I'd be happy to address these and other issues further.

Mr. Chairman, this concludes my opening statement. I will be happy to answer any questions you or other members of the subcommittee may have. Thank you.

[The prepared statement of Mr. Toye follows:]

Mr. Chairman and Members of the Committee

Thank you for the opportunity to appear before this committee to discuss financial management within the Department of Defense (DoD). Improvement of the Department's financial management is a top priority. DoD leaders have undertaken the most comprehensive reform of financial management systems and practices in DoD history. Progress has been substantial, but much more work still lies ahead.

The Department's financial management reforms aim to streamline and redesign DoD financial processes in order to make them optimally effective and to reduce costs. Reforms also seek to ensure that DoD financial management fulfills the needs of its leaders, satisfies statutory requirements, minimizes the potential for fraud, and provides superior customer service.

Today, I want to address general DoD Financial Management Reform, Auditable Financial Statements, Problem Disbursements, and then provide a progress report on our various financial management reform efforts. Additionally, I want to highlight how the Department is moving to strengthen its internal controls, and how DoD is adopting best business practices.

DOD FINANCIAL MANAGEMENT REFORM

Financial management in the DoD is a work-in-progress designed to fulfill the needs of its leaders, meet statutory requirements, maximize efficiency, minimize fraud, and to provide superlative customer services. There have been notable successes, but progress is slow in some areas. It is impossible to reverse decades-old problems overnight and some reforms will require several years of transition, reengineering, and modernization.

In moving ahead, DoD financial management reform must accommodate two unavoidable constraints. First, the Department cannot halt its financial operations while it fixes outdated business practices and flawed systems. Every day, the Department must manage payrolls, process payments, and produce financial reports. These daily operating requirements impose a practical consideration on all plans for changing systems and business practices.

A second constraint is that lasting reform demands consensus and collaboration. Few solutions rest exclusively within the jurisdiction of the financial management community. The development of an infrastructure capable of providing accurate and reliable financial management information and achieving auditable financial statements is essential to the Department. Such an infrastructure must be built around the integration and transfer of financial information between financial systems as well as between "nonfinancial feeder" systems and financial systems. The acheivement of such an infrastructure is essential if the Department is to enhance the sharing of information and avoid redundant and sometimes conflicting data. The DoD financial community must play a key leadership role in developing this infrastructure.

DoD's current leadership is committed to making financial management reform a hallmark of its stewardship. Progress to date has been substantial, and the Department is determined to complete this historically significant challenge.

AUDITABLE FINANCIAL STATEMENTS

The DoD Inspector General has identified the lack of adequate accounting and finance systems as the primary deficiency preventing the audit community from rendering more favorable audit opinions on the Department's financial statements. Clearly, the lack of integrated systems--both financial and nonfinancial systems--has been a major inhibitor in our ability to achieve auditable financial statements. This current lack of an adequate infrastructure built around the integration and transfer of financial information between financial systems, as well as between "nonfinancial feeder" systems and finance systems, is a DoD-wide management challenge.

On July 30, 1997, the Department mandated the use of the U.S. Government Standard General Ledger throughout the DoD in all systems that originate information that ultimately will be used in, or passed to, financial systems. The U.S. Government Standard General Ledger will replace the DoD Uniform Chart of Accounts and should provide the Department with the capability of supporting the preparation of auditable Chief Financial Officer financial statements.

The implementation of the U.S. Government Standard General Ledger will permit the Department to design an archectiture built around the use of standard data to facilitate the sharing of data and the standardization of interfaces. Such interfaces are expected to collect financial transaction data and update subsidiary and general ledger accounts.

In conjunction with this effort, the Department continues to work to clarify data management responsibilities and to assign responsibility and accountability for recording, maintaining and managing financial data not only in financial systems but also in feeder systems--to include information needed to meet new accounting standard requirements. The inclusion of nonfinancial feeder systems in these efforts is important because feeder systems generate as much as 80 percent of the dollar value associated with data used in financial processes that ultimately are required to be included in the Department's auditable financial statements.

Detailed plans and schedules to eliminate accounting and financial reporting deficiencies in the Department's finance and accounting systems have been developed and continue to be reviewed and updated. Where warranted, an incremental approach is being used to transition customers with similar requirements to similar interim migratory systems in order to conserve resources and to quickly collapse the population of existing systems that must be supported, and to facilitate the transition to more desirable systems. At the current time, migratory systems are being deployed while also being enhanced to correct systems deficiencies. In some instances, systems integration/interface is expected to be achieved through implementing a central database that provides a warehouse capability to store and share data for financial management purposes. Ultimately, it is anticipated that most information will be transferred in an electronic mode for applications such as vendor invoicing, contract payments, travel settlements and direct deposit of military and civilian pay. However, the new system architecture is not expected to be in place until 2003.

Practical Considerations of Audited Financial Statements

On March 31, 1998, the General Accounting Office (GAO) expressed its first audit opinion on the Consolidated Financial Statements of the U.S. Government. The GAO disclaimed an opinion citing its inability to attest to the reliability of significant portions of the financial statements--including deficiencies related to the DoD in the areas of (1) property and inventory, (2) environmental and disposal liabilities, and (3) the costs of government operations.

Despite the progress to date, the Department still has considerable challenges ahead before it will be able to prepare auditable financial statements. However, it should also be noted that the GAO report cites deficiencies in some of the findings, such as "Preparation of Consolidated Financial Statements" and attributes those deficiencies to the agencies without advising the reader that the consolidated financial statements have been prepared in FY 1998 formats which are significantly different from the FY 1997 report formats. The FY 1998 formats are significantly different because they are designed to accommodate new reporting requirements for new federal-wide accounting standards that are not effective until FY 1998.

Unfortunately, the GAO audit report also fails to alert the reader that reporting policy surrounding some reported deficiencies are yet unsettled while other deficiencies noted in the GAO report are being cited prior to a requirement for applicable information to be fully reported.

Property, Plant and Equipment and Inventory

The GAO report states that hundreds of billions of dollars of the more than $1.2 trillion of Property, Plant, and Equipment reported assets are not adequately supported by financial and/or logistical records. The GAO concluded that because the government does not have complete and reliable information to support its asset holdings, the GAO could not satisfactorily verify the existence of all reported assets, substantiate the amounts at which they were valued, or determine whether all of its assets were included in its financial statements.

Information on the Department's plant, property and equipment, as well as its inventory, often is captured in logistical systems--not financial systems. Additionally, such systems were not required to include historical (original acquisition) costs in many instances. Current standards now require historical cost data--data that was not required previously.

This has created a considerable challenge for the Department, and the Department continues to work toward full compliance with the new standards.

Although matters such as these are not addressed in the GAO report, in order to fully appreciate the reporting difficulties that the Department faces, it is important to understand some of the more practical issues surrounding the amounts reported, or not reported, by the Department. For example, the GAO and the DoD have different interpretations relative to some of the reporting requirements. The Department believes certain amounts should be reported one way, while the GAO believes that the amounts should be reported differently. To the extent that the Department reports amounts in a manner that is inconsistent with the manner that the GAO believes that such amounts should be reported, audit reports might state that the Department failed to properly report amounts--inventories, for example. However, the reader may not be aware that the underlying issue may not be the ability of the Department to identify and report on such items, but rather the manner that certain amounts were reported.

Additionally, property, plant and equipment are required to be reported at their historical acquisition cost. Government-wide record retention requirements provide that copies of supporting documentation need not be retained beyond a specified period of time--generally 6 years and 3 months after final payment for plant, property and equipment. Since much of the Department's plant, property and equipment is more than 6 years old--many of the Department's original acquisition records have been forwarded to a records depository where they were subsequently destroyed in accordance with government-wide record retention practices. Therefore, the Department lacks "hard copy paper" documentation to support the original cost of much of its plant, property and equipment. Even though the Department's property records may report such cost data, if the data is not supported by copies of applicable cost vouchers, auditors have rejected such cost data as being unsupported since copies of the actual cost vouchers are not available for review.

Until practical issues such as these are resolved, the auditors might feel compelled to report that the Department's property, plant and equipment amounts are not adequately supported, or properly reported. However, such reports would not necessarily mean that the Department does not have information regarding the value of its plant, property and equipment. It could mean only that such information is not sufficient to pass current rigorous audit standards.

Environmental Liabilities

The Department has not yet fully institutionalized a process for reporting environmental liabilities compliant with new standards that are effective with FY 1998. However, the Department expects to do that later this year. The GAO audit report states that $213 billion of hazardous waste and remediation of environmental contamination relative to the Department's major weapons systems was not reported. The audit report does not advise that the reporting of environmental contamination relative to the Department's major weapons systems is a new accounting requirement not scheduled to take effect until FY 1998.

Costs of Government Operations

The GAO auditors reported that they were unable to determine whether the amounts reported in the Statement of Net Costs were properly classified in individual net cost categories. The financial statements of the government have been restructured to fit the revised FY 1998 financial statement formats adopted by the Office of Management and Budget (OMB), the GAO, and the Department of the Treasury. Unfortunately, the revised formats were developed in concert with new account standards not slated to take effect until FY 1998. Those new accounting standards contain material differences in the accounting for, and reporting of, net costs.

PROBLEM DISBURSEMENTS

Next, I would like to discuss improvements regarding problem disbursements within the DoD. Problem disbursements in DoD financial operations occur when an expenditure is not initially reconciled with a specific obligation. Such occurrences are the result of a practice whereby expenditures are made by an organization other than the organization that maintains the official obligation accounting records, and expenditure records and the obligation records are not linked electronically. In those instances, problem disbursements may occur when payments are made after validation of the receipt of the related goods and services, but before ensuring there is a clear path back to a specific obligation. This practice is being phased out as quickly as feasible, and DoD has made substantial progress in reducing problem disbursements. For example, in June 1993, the Department's problem disbursements totaled $34.3 billion; as of January 31, 1998, they had been reduced to $10.4 billion.

The solution that the Department is pursuing for preventing problem disbursements is a contract database shared by two future standard systems: the Standard Procurement System and the Defense Procurement Payment System. The shared database would be the one source for contract management, payment, and accounting data. The Standard Procurement System effort would merge the Department's two procurement functions encompassed by the contract award and administration processes. The Defense Procurement Payment System would be used for calculating contract and vendor payments, grants, and other agreement entitlements, and for generating transactions to populate the associated accounting records. The Standard Procurement System and Defense Procurement Payment System are expected to replace the Mechanization of Contract Administration Services system in the early 2000's. (The Mechanization of Contract Administration Services system currently is used by the Defense Finance and Accounting Service (DFAS) Columbus Center to make contract payments.)

Prevalidation, the procedure of matching a disbursement to an obligation before (rather than after) a payment is made, has helped to reduce problem disbursements. Thresholds for applying prevalidation have been established at each DFAS center. To eliminate problem disbursements, the DoD plan is to:

- Gradually lower the prevalidation threshold until all payments are prevalidated.
- Provide disbursement voucher information via the DoD Intranet for access and recording by accounting stations.
- Pilot test the matching of payments and accounting data from the current financial management systems using data warehouse techniques.
- Record all accounting events within a DFAS corporate database, providing immediate access to all entitlement, disbursing, and accounting stations.

Although DoD's problem disbursements have been a serious issue, there is little basis for concluding that the expenditures involved were improper. Each expenditure was made only after a Department official confirmed receipt of the subject goods or services and ensured that the payment was made in accordance with a valid contract. That notwithstanding, DoD has an extensive Business Process Reengineering effort under way to improve its disbursement process and its ability to match disbursements to obligations in a more timely manner. The Department anticipates the business process engineering effort, the implementation of two new systems (the Standard Procurement System and the Defense Procurement Payment System) and the prevalidation initiative to be the catalyst for a continuation of a steady reduction in problem disbursements.

The GAO frequently states that there is a category of problem disbursements called in-transit disbursements. However, the Department does not consider in-transit disbursements as problem disbursements. An in-transit disbursement is a disbursement transaction that has been transmitted by a paying office to an accounting office, but has not yet been received, or processed, by an accounting office. For example, the DFAS Columbus Center may pay a contractor's invoice; however, the official accounting office may be the DFAS Indianapolis Center. Thus, the Columbus Center must report the disbursement to the Indianapolis Center so that that Center can record the disbursement transaction in its official accounting records. If the Columbus Center has transmitted the disbursement transaction to the Indianapolis Center and that Center has either not yet received the transaction to post the transaction to the official accounting records, that disbursement transaction is referred to as an in-transit disbursement.

In-transit disbursements are the result of a time-consuming, antiquated business process. The practice of one subsidiary paying another subsidiary's bills is not a common commercial business process; however, the Department adopted this policy decades ago and accepted the long delays of mailing the documentation to the accounting offices. The

Department has undertaken an initiative to eliminate this business practice to the extent feasible because these long delays are no longer acceptable. In the meantime, the Department has reduced the amount of in-transit disbursements from $16.8 billion in June 1993 to $3.9 billion in January 1998. The Department changed its reporting procedures for in-transits to allow greater visibility of in-transit disbursements, and to provide a mechanism to identify the specific areas causing in-transits not to be posted in a more timely manner. Once identified, processes will be initiated to further reduce these in-transit disbursements.

PROGRESS REPORT ON DOD FINANCIAL MANAGEMENT REFORM

The Defense Finance and Accounting Service and the Consolidation of Financial Management Operations

Since its activation in January 1991, the DFAS has been the Department's pivotal agent for financial management reform and consolidation. The DFAS now processes a monthly average of nearly 9 million payments to DoD personnel; 2 million commercial invoices; 675,000 travel vouchers/settlements; 550,000 savings bond issuances; and 340,000 transportation bills of lading, with total monthly disbursements averaging $22.2 billion.

Before consolidation began in FY 1994, the Department's financial management operations were conducted at over 330 field installations or sites. Since then, the Department has moved to five DFAS Centers and 21 operating locations. In the process, the Department has been able to eliminate redundancy and unnecessary management layers, facilitate standardization, improve and speed up operations and service to customers, increase productivity, and enhance financial management support to DoD decision makers. The current Defense Reform Initiative calls for the DFAS to make even further consolidations.

Expanding Competition to Improve Services and Reduce Cost

DoD financial managers are participating in the Administration's effort to use competition within the government and with the private sector to improve support services and save money. For example, during FY 1996, the Department consolidated debt and claims management activities into one location, saving $8.5 million annually. A facilities, logistics, and administration study, completed in May 1997, will save $4 million annually. Another A-76 study (on Defense Commissary Vendor Payments) was completed in October 1997, with the government's Most Efficient Organization (MEO) being selected over the private sector vendor. The MEO, which was implemented in March 1998, is projected to realize savings in excess $10 million annually.

The Department has active A-76 competition studies in the areas of commissary accounting, DoD transportation accounting, and DoD depot maintenance accounting. Additionally, the Defense Reform Initiative directed the DFAS to initiate A-76 studies in the areas of civilian pay and military retiree and annuitant pay.

Consolidation of Finance Systems

There are two types of DoD financial management system--Finance and Accounting. Finance systems process payments to DoD personnel, retirees, annuitants, and private contractors. Accounting systems record, accumulate, report, and analyze financial activity. The Department has 156 finance and accounting systems, down from 324 in 1991 when the DFAS was established.

The number of DoD finance systems has been reduced from 127 in 1991 to 34, with a resulting annual savings of $77 million. The long-term goal is to reduce the number of DoD finance systems to nine.

The consolidations of finance systems has been completed for retiree and annuitant payments and debt management. The Department's ongoing consolidation of other finance systems includes:

- Defense Civilian Pay System (DCPS). Approximately 703,000 civilian payroll accounts have been transferred to DCPS; 25 systems have been eliminated and 348 decentralized payroll offices have been eliminated. By mid-1998, all DoD civilian employees will be paid by DCPS from just three locations.

- Defense Joint Military Pay System (DJMS) and the Marine Corps Total Force System (MCTFS). Today there are four military pay systems, with 95 percent of military members being paid by DJMS and MCTFS. By the end of FY 2001, DJMS will be fully implemented and all service members will be paid by either DJMS or MCTFS, eliminating 22 military pay systems.

- Defense Procurement Payment Systems (DPPS). DPPS currently is being developed as a standardized DoD contract and vendor payment system. It will replace nine current vendor pay systems, as well as the Mechanization of Contract Administration Services System.

Consolidation of Accounting Systems

The Department has reduced the number of accounting systems from 197 in FY 1991 to 122 in FY 1997. Simultaneously, DoD has been improving the remaining systems to make them compliant with generally accepted accounting principles and capable of producing auditable financial statement information. The Department continues to work hard to eliminate as many as 100 accounting systems; and by FY 2003, DoD expects to have reduced the number of accounting systems to no more than 23. At least as important also are other ongoing improvements to the remaining systems--to make them more compliant with the Chief Financial Officers Act and capable of providing accurate, timely, and auditable financial statements.

STRENGTHENING INTERNAL CONTROLS

Reforming the Contractor Payment Process

For the past 30 years, vouchers for goods and services purchased on government contracts had to be submitted to government contracting officers or the Defense Contract Audit Agency (DCAA) for approval before being sent to a government payment office. This process substantially delayed payments and required extensive effort by the DCAA, government contracting officers, and contractors themselves. The Department now allows direct submission of vouchers to the DFAS by qualifying contractors. The DCAA continues to provide oversight by periodic review of contractors and by examining a sampling of paid vouchers. This reform will save substantial auditor time, without putting accountability at risk. It also facilitates the transmission of contractor voucher payments using Electronic Data Interchange, another source of savings and efficiency.

Computer Security and Fraud Detection

In June 1994, the Department established Operation Mongoose to detect fraud and reduce the vulnerability of DFAS's computer networks to intrusion. While Operation Mongoose is designed to detect potential cases of fraud or abuse in the tens of millions of financial transactions undertaken every year, it also has a more important purpose--to identify potential weaknesses in the underlying controls to make it much harder for would-be culprits to abuse the system.

Improved Financial Management Regulations and Procedures

The Department is continuing to standardize, improve, and simplify its financial management regulations and procedures. DoD financial management policy and procedures have been consolidated into a 15 volume "DoD Financial Management Regulation" (DoDFMR), which is replacing thousands of pages of separate DoD regulations. Because the 15 volumes of the DoDFMR have been posted to a DoD web site, routine large-scale printings and distributions of the volumes have been terminated. The DoDFMR is now available free via an electronic media or may be purchased in a CD-ROM or paper copy.

Reform Reporting and Valuation of Inventory

The Department is taking aggressive action to improve how it accounts for inventory. Conversion of inventories from DoD's standard (selling) price to the required latest acquisition cost, or historical cost, currently is being accomplished. Enhancing inventory management systems to capture accounting information is expected to provide for automated inventory valuation, costing of goods sold, and other elements that enable accurate assessment of net operating results.

Reporting and Valuation of Real and Personal Property

DoD's accounting systems were not designed to account for, and report on, the Department's real and personal property. Instead, financial information for these assets is obtained from various property data systems, which for the most part are not integrated with the Department's accounting systems. To fix this, the Department is deploying a DoD-wide integrated property accounting system. This system is expected to provide for financial control over real and personal property, replace over 150 separate property systems in DoD organizations, and provide necessary financial data to the accounting systems.

ADOPTING BEST BUSINESS PRACTICES

A critical aspect of the Department's financial management reform is to adapt and adopt successful business practices from the private and government sectors. The goal is to make DoD business practices simpler, more efficient, and less prone to error. This is being achieved by the revision of existing policies and procedures, increased standardization of data, consolidation of operations and enhanced capabilities and compatibility of systems.

Electronic Payments

- Electronic Funds Transfer (EFT). The Department is using EFT to reduce the cost of disbursements. Over 91 percent of civilian employees and military members paid by DoD have their pay directly deposited into their accounts. During FY 1997, DoD's Direct Deposit participation rate for travel payments increased from 17 to 48 percent.

- Electronic Data Interchange (EDI). The DFAS is using EDI to send remittance information directly to vendors and currently is working to receive and process EDI contracts and contract modifications into finance and accounting systems.

Electronic Audit Working Papers

Audit working papers are key components of audits performed by the DCAA. They document DCAA's audit work and sometimes are shared with the customer as backups for audit reports. The DCAA recently implemented an automated working paper process to make its audit services better, faster, and less expensive. The DCAA acknowledges the audit request, performs the audit, and issues the audit report to the customer electronically. In addition, automating the process improves DCAA's internal communications for supervisory review and report issuance.

As a result of this reform, the DCAA can serve customers and obtain feedback on their services faster, helping to reduce the cycle time for negotiations. The DCAA's new working paper process also supports DoD's efforts to improve the procurement process and will help achieve DoD's overall goal to become paperless.

Garnishment Operations

The DFAS is continuing the reengineering of the processes by which the Department garnishes the pay of its civilian and military personnel for child support, alimony, commercial debt, and divisions of retired pay. DoD garnishment operations have been consolidated at DFAS Cleveland Center, which processes about 12,000 garnishment orders per month. Initial reengineering efforts have reduced staffing requirements significantly and are estimated to save $19 million over a five-year period. Over the next year, the DFAS plans to implement major improvements--most notably to integrate EDI and imaging technology, and an integrated garnishment system that will provide an electronic interface with the DFAS pay systems. The first interface with the DCPS was successfully implemented in August 1997. The remaining interfaces are scheduled to be completed by December 1999.

Government-Wide Purchase Card Expansion

The Department's participation in the government-wide purchase authorization card program has grown to include over 107,000 cardholders with purchases totaling $2.2 billion for FY 1997. DoD's goal is that, by FY 2000, the purchase card will be used for 90 percent of its micropurchases, those purchases costing $2,500 or less. Expanded use of the government-wide purchase card--together with other of the defense reform initiatives--is expected to allow retail-level inventories to be reduced from $14 billion in FY 1996 to $10 billion by FY 2001.

The purchase card streamlines purchase approval processes, reduces purchasing and accounting documentation, reduces costs, and speeds up vendor payments. It enables the Department to use summary accounting for groups of purchases instead of detailed lines of accounting for each transaction, and permits an accelerated payment and invoice reconciliation process with the purchase card issuer.

The DFAS processes about 10 million commercial invoices per year, over three-quarters of which are below the $2,500 (micropurchases) threshold that exists for the purchase card. Numerous initiatives are now being pursued to encourage more of these purchases to be made with the purchase card. Using an accelerated invoice payment and reconciliation process will enable the DFAS to make payments faster, virtually eliminating interest payments. Using summary accounting for groups of purchases will reduce the costs, time, and size of the work force needed to process invoices; permitting the customer to receive procurement efficiencies and lower processing.

Temporary Duty Travel Reengineering

The Department continues to implement its simplification of the temporary duty travel process for all DoD personnel. Since our last update to you on this initiative, the number of test sites for revised policies have increased from 27 to 39 sites. Results from the tests show significant reduction in voucher processing time, labor costs, process steps, payment cycle time, as well as significant increases in customer satisfaction. To improve the efficiency and quality of travel services, the Department is developing an automated information system, the Defense Travel System (DTS), that will integrate common user interface services and traditional commercial travel office services. The DTS will be phased in by geographical region, with initial implementation in the U.S. Mid-West scheduled for the fourth quarter of this fiscal year.

New DoD temporary duty travel policies include:

- The use of simplified entitlements that delegate to appropriate officials the authority to approve exceptions to standard arrangements.

- Expanded use of a government-sponsored, contractor-provided travel card to pay for expenses related to official business travel (travel advances, airline tickets, lodging, meals, conference registration fees, and other costs).

- Expanded use of electronic funds transfer to reimburse travelers.

Before fully deploying its new DTS, the Department pilot tested these and other revised policies at 27 sites, representing each of the Services and several defense agencies. Results from the test show an approximate 50 percent reduction in process steps, an over 50 percent reduction in process cost, an almost 50 percent reduction in payment cycle time, and significant improvement in customer satisfaction of both travelers and their authorizing officials.

Ready Reserve Travel Reengineering

The Department also formed a Ready Reserve Travel Task Force to apply the lessons learned from Temporary Duty Travel reengineering to the Reserve Components. The goal is to apply the efficiency and effectiveness of the DTS to the management of Reserve Component Travel. The Ready Reserve Task Force has determined that the DTS generally is compatible with the Reserve Component travel administration processes. The Department expects to identify and effect the process and systems changes needed to integrate the Reserve Components fully into the DTS automated process.

Permanent Duty Travel Reengineering

The Department moves approximately 800,000 military and civilian personnel per year: 775,000 military personnel during periodic rotational assignments, and 25,000 civilian personnel as a result of reassignment actions. A Permanent Duty Task Force is reviewing the process used to relocate DoD personnel. That review has identified "best in class" processes used in the private sector and found that the Department's processes are highly labor and time intensive. Following additional efforts, the Department expects to be able to streamline the relocation process and enhance the quality of life for DoD personnel subject to frequent moves.

Digital Signature

To achieve the goal of a paperless process, DoD leaders worked with the Departments of Commerce and Energy and the GAO to develop a software specification that creates a digital signature that is compliant with federal standards. This should enable the Department to move to paperless processes as users will be allowed to sign documents electronically. This process will be tested in the DTS and eventually exported to other functional areas within the Department.

Standardization of Data

In addition to consolidating finance and accounting systems, DoD is establishing, or has established, a DFAS Corporate Information Infrastructure to support:

- Use of common data elements for the collection, storage, and retrieval of finance and accounting data.

- Use of common transactions.

- Movement of common transactions and data among systems.

Also supporting this reform is an ambitious effort to standardize and share acquisition data. This effort will greatly improve the interactions between DoD procurement systems and the financial systems that process and account for payments of procurements.

CLOSING

Enhancing the Department's processes and systems to enable the Department to produce auditable financial statements holds continuing challenges and constitutes an ambitious agenda. In pursuit of that objective, the Department continues to modify and upgrade accounting, other financial systems and nonfinancial systems to build a much-improved financial infrastructure within the Department. The results of this effort will provide better information and discipline to better manage the Department's resources and remain effective stewards of the resources provided by the Congress and the American people. The Department is proud of its progress to date and expects to continue to strive to achieve its goals as expeditiously as possible.

Mr. HORN. Well, thank you very much. Let's start with missing missile launchers, among other things. Now you've got a whole series of objects that were reported in the consolidated balance sheet statement for the Federal Government. What kind of assurance can you give us that we do not have other things missing that are worth billions of dollars? Because there are quite a bit of things missing, even though you have got a huge inventory. I realize that, but what are our controls on this?

Mr. TOYE. I'd like to repeat something that the IG said this morning, and GAO verified, and then I'd like to talk about the missile launcher itself.

When the auditors went in to verify the accuracy of data in our systems, the Army and the Air Force systems passed that test; 8 of the 11 systems in the Navy passed that test, and we can come back and talk to the issues in the Navy in a minute. With regard to the launcher, I want to assure this committee and the American people that the Department of Defense knows where these missile launchers are. The Army has over 500 of this particular type of——

Mr. KUCINICH. Will the gentleman yield?

Mr. HORN. OK.

Mr. KUCINICH. Why don't you just tell the General Accounting Office, then?

Thank you.

Mr. TOYE. Let me give you some background on this.

The General Accounting Office did not do the audit of these missiles; that was done by DOD auditors. What happened in this instance is that we had a launcher attached to a Humvee. The Humvee was transferred to one unit. The launcher was transferred to another unit. The DOD auditors went in and did a review at the unit to which the Humvee was transferred. They did not find the launcher there because the launcher had been transferred to another unit. The DOD auditors did not raise this as an issue.

GAO auditors came behind the DOD auditors and, in effect, looked over their shoulder and used their work papers. And I believe the characterization that the launcher was missing came from the GAO. When the Department of Defense heard that the GAO was indicating that the launcher was missing, we immediately contacted the auditors to get some more information on what missile launcher they thought was missing and why they thought it was missing. With that information, we indeed were able to identify the launcher that they were talking about and then, of course, we could identify where its location was.

Mr. HORN. Did anything change in our accounting for this type of situation, where you have got the launcher in one place and the missile in the other? Are these two things we need to check to not have that experience again?

Mr. TOYE. Yes, there is a lesson here. The issue here was the serial number. The serial number for the Humvee was listed as the serial number for the unit, the unit being both the Humvee and the launcher. And, indeed, there should have been two serial numbers, because there's one for the Humvee and one for the launcher. Had a review been done by the serial number of both the launcher and the Humvee, both units would have been identified for the GAO auditor.

Mr. HORN. Are those DOD serial numbers or are they manufacturers' serial numbers?

Mr. TOYE. Mr. Chairman, I do not know the answer to that question.

Mr. HORN. Well, the reason I ask that is, if it is a continuous number problem, that could confuse somebody that is doing inventory. On the other hand, if it is some manufacturer's number, it might be readily apparent that there is something wrong here; this is not the way the numbers we have on missiles or the numbers we have on Humvees, whatever the case may be, that track all this.

Have the people in your office figured out a way to solve this problem so that they know immediately that there is something that is not right here?

Mr. TOYE. Mr. Chairman, this is a logistics issue, and I hesitate to get too far afield from the financial world. But it is my understanding that the DOD logistics community is working toward an environment where every piece of DOD property will have its own identification number. In most cases, that already exists. But I hesitate to get too far into the logistics arena.

Mr. HORN. You are from Mr. Kaminski's office, as I remember. Maybe you can explain to us the problems we have between the acquisition of items and then their assignment to units and then how we account for them. This is where I think a lot of the $25 billion was missing; they just had not matched the acquisition contract with the inventory records to know that, yes, I bought it, but where is it now?

Is your office doing anything to coordinate with the financial people so we can find these things?

Ms. SPECTOR. Sir, I represent acquisition. My specialty is procurement, and I'm not an expert on logistics. However, my limited understanding of this is we are keeping track now of secondary items, like spare parts. The problem that you addressed earlier of commanders in chief not knowing where things are, I believe that problem is largely solved. We've put hardware and software at all of the unified commands in Europe and the Pacific central command that tells the commander in chief where every shipment is, what's on the shipment, so he knows what's coming to him and what he has in the logistics systems. As far as these primary items, like a Humvee vehicle, my understanding is the military departments track those themselves.

I think the ultimate answer on this is electronic tagging or electronic recording and computer reading of the location of everything. We're not there yet. I think that's the goal, to identify the movement of systems and where everything is. There has been progress toward that, but we're not there yet for everything. I can get you more specifics if you wish, but that is my understanding of where we are and where we are going in the logistics area as far as keeping track of all of this.

Mr. HORN. Well, that would still require a serial number I assume and this would be a global positioning use.

Ms. SPECTOR. It would be a DOD serial number is my understanding. Now, in some cases we are having contractors put bar codes on things like spare parts so that they can be read by a bar code reader. In many cases we're doing that. But on primary items that are an assemblage of several systems, DOD would assign codes to those, is my understanding.

Mr. HORN. Now, you were not here probably 2 years or so when we got into this—maybe you were—at the Columbus Processing Center. Did you, as Director of Procurement, and your staff take a look at that situation and see why they were just writing checks without, or at least a misreading of, the acquisition document?

Ms. SPECTOR. Again, some of this involves mistakes that were made in these very long lines of accounting that Ms. Hill described. You'll have a citation on a contract assigned by a fiscal person for certain moneys on that contract that may be up to 55 characters long. Before the age of automation, or even in the age of some automation, you have people putting those numbers in manually. When there is a mistake made, you pay from the wrong account and it doesn't match up later. We have several initiatives under way to improve that system to avoid unmatched disbursements. One is to eliminate a lot of these lines of accounting and, to the maximum extent practicable, keep them at the appropriation level. There will be a letter going out shortly from the Under Secretary for Acquisition and Technology and the Comptroller to limit those lines of accounting.

We are also automating so that the input on the long line of accounting goes in once and from there on it is handled by computers in shared data warehouses. We have a standard procurement system under way that will do some of that. DFAS, Defense Finance and Accounting Service, is working to use that data to prevent the mistakes made as each clerk types in these long lines, several of them on a contract. So there are things under way to improve this. We're not there yet, everywhere.

Mr. HORN. What is the policy in terms of when one does an inventory? Is it annually? Is it quarterly? Is it monthly? What?

Ms. SPECTOR. I don't know the answer to that. It is not in my area. I can get you that answer. I don't know.

Mr. HORN. How about it Mr. Toye, do you know the answer to that?

Mr. TOYE. No, I do not, Mr. Chairman.

Mr. HORN. Well, let's get it and put it in the record.

[The information referred to follows:]

Some inventory items, such as precious metals, small arms, narcotics, and radioactive items, are subject to an annual physical inventory. Statistical sampling techniques are used to track other inventory items, as is a common practice in the private sector.

Mr. HORN. Does GAO know it or the Inspector General's Office in Defense know it? Join us.

Mr. WARREN. Typically, there are annual cycles for inventory at each of the individual locations and activities, and then for the individual property books. When the accountable officers transfer, there is a reconciliation at that point in time as a general proposition.

Mr. HORN. Mr. Warren, it seems to me there is a difference, I guess in the property book versus the records on case. Is there a way to reconcile that with what the GAO sees?

Mr. WARREN. Between the central systems, yes, there is a reconciliation process as I understand it. At the property book level, if there are discrepancies, that is to be worked out at that individual unit level to the satisfaction of the commanding officer at that particular location, the accountable officer for that property book.

Mr. HORN. Now, is that accountable officer the commander of the base or is it a finance officer?

Mr. WARREN. It would be an individual that had been designated that responsibility from the commanding office of the base.

Mr. HORN. Have we figured out a way to take the data out of those property books and input them in your accounting system that Mr. Toye runs?

Mr. TOYE. Mr. Chairman, if I may, the long-term solution to this issue is indeed the integration of systems which will, in turn bring the integration of information. That is indeed the Department's proposed solution. We propose to integrate the Defense Property Accountability System with the Department's financial systems. That effort is under way. It is going to be a long-term effort.

The issue here is the sharing of information electronically as opposed to the sharing of information manually. When information is shared in a manual mode, the opportunities for errors obviously increase significantly. What we need to do is, stop sharing information manually, and share it electronically. That is the corrective action that the Department of Defense has planned.

Mr. HORN. How long do you think that will take? What is your estimate on that implementation to make it operational?

Mr. TOYE. It's difficult to answer that question. The initial target was fiscal year 2000.

Mr. HORN. So that means we'll have it by 2004, I take it?

Mr. TOYE. Mr. Chairman, I hope we have it by 2000, but I cannot sit here and absolutely guarantee that.

Mr. HORN. That is why I said 2004. It seems to me you have got enough going on with the year 2000 problem right now to give that your full attention, as they are in IRS and every other agency, I hope.

Mr. TOYE. Yes.

Mr. HORN. Well, what can you do to give us a little feeling of happiness and reliance on the acquisition procurement empire, the financial empire, and the three services, plus the Marines, that something will happen in this area? Do we have integrated teams between those two under secretaries where you are working on the problem together?

Mr. TOYE. Yes, we are working very closely together. And as Ms. Spector mentioned, what we have planned is an automated system in the acquisition world and an automated system in the financial management world that will share the same data base; they will share the same information and they will share it in an electronic mode and that will eliminate many of the problems that we have today. Again, this goes back to the manual entering and reentering of information. Because some of these so-called long lines of accounting contain multiple characters, it only takes one character to be off to result in a problem disbursement.

Let me mention if I may, Mr. Chairman, that the Department of Defense now has a policy in place called prevalidation where we fully make a payment in many instances. The threshold will vary depending upon the system involved and where the payment is made, but in some cases it is all the way down to zero. If the paying station is different from the accounting station, which is often the case in DOD, the paying station needs to prevalidate with the accounting station that an obligation has been made, and that funds are available to make the payment. They will do that and then transmit—they will then pay the bill and transmit the information to the accounting station.

It is quite possible the transmission stage that an error will be made, a digit will be transposed. So even though we know that the payment is accurate because we ensure that it is a legitimate bill before we pay it, even though we have prevalidated the payment with the accounting station, in transmitting the information to the accounting station, an error can occur that results in a problem disbursement. This then needs to be researched and the error needs to be corrected; and then it can, and will be posted.

Mr. HORN. Well, my time is up. I will yield 20 minutes to the gentleman from Ohio.

Mr. KUCINICH. Thank you very much, Mr. Chairman.

I would like to ask Mr. Toye to comment on the testimony by the Inspector General and the Department of Defense where she says that, quote, "My office has issued 181 audit reports on financial and accounting matters since I testified before you, and only a handful have been good news." It goes on to say that "I cannot report to you that the Department has successfully corrected the many shortcomings in its accounting and financial systems."

Mr. TOYE. Under the CFO Act——

Mr. KUCINICH. CFO?

Mr. TOYE. Under the Chief Financial Officer Act, the Department is required to prepare financial statements which the Inspector General is required to audit. Within DOD, we prepare a number of financial statements for different entities. The problems that we have in DOD in terms of the deficiencies in our systems are unfortunately applicable to many reporting entities. So audits we may have in a particular year may result in 19 different audit reports with the same finding because it is a DOD-wide deficiency and appears in each one of the reporting entities that is required to have an audit that results in an audit report. So the numbers are somewhat misleading. But let me also say——

Mr. KUCINICH. Which numbers are misleading?

Mr. TOYE. The number of audit reports do not, by themselves, indicate the number of deficiencies because the same deficiencies may be, and in many instances are, contained in different audit reports.

Mr. KUCINICH. So how many deficiencies are there, then?

Mr. TOYE. I don't know that I can answer that question. I would say there are probably a handful of what I would call major deficiencies in the Department of Defense in the financial management arena.

Mr. LIEBERMAN. Can I answer that, Congressman?

Mr. KUCINICH. Of course.

Mr. LIEBERMAN. In the last Secretary of Defense Annual Assurance Statement presented to the Congress, I think he listed 29 material control weaknesses in the finance and accounting area.

Mr. KUCINICH. I would ask Mr. Toye to comment on the finding by the Inspector General for the Department of Defense which speaks to the reason for the disclaimer of opinion on all DOD general fund statements for 1997, saying that the accounting system supporting Department of Defense general funds cannot compile and report accurate and reliable information, that the accounting systems supporting Department of Defense general funds continue to lack integrated double entry transaction-driven general ledgers compiled and reported unreliable and unauditable information.

What do you have to say about that?

Mr. TOYE. Our accounting systems often do not provide the type of audit trail that the auditors are looking for. Our accounting systems were designed in a different era. They were designed to do appropriation accounting, to keep track of the dollars appropriated by the Congress, to ensure that the dollars were spent in the manner intended by the Congress, for the purpose that the Congress intended that they be spent for, and we conform to the limitations and restrictions imposed by the Congress.

Today these same systems are being asked to do commercial- or business-type accounting and they were not designed to accomplish that. So we do indeed have deficiencies in our accounting systems compared to new standards that those systems were not designed to meet.

To correct that situation is, we have identified those systems that we think do a better job and we are collapsing systems. As you heard earlier, we had 324 systems in 1991, we've collapsed that to 156 systems. We are hoping to go down to 32 systems. We are not only eliminating the systems that don't do as good a job. In the remaining systems, we are upgrading those systems, we are enhancing them to meet the new accounting standards that are being imposed, standards that were not in effect at the time these accounting systems were developed.

Mr. KUCINICH. So continuing on with the observations of the Inspector General for the Department of Defense. She talks of information not auditable because—and this is a quote—"The accounting systems cannot produce an audit trail of information from occurrence of a transaction through its recognition in accounting records and ultimately to the general fund financial statements."

Are you saying then, Mr. Toye, that that is true by definition because you just do not have that kind of accounting system?

Mr. TOYE. I'm definitely not saying that our accounting systems can meet current audit standards. They cannot. Property records are maintained in logistics systems, not financial management systems.

Now, to satisfy the audit trail requirements, DOD needs to provide receipts to verify the costs of the values that are in its property systems. In many cases we're talking about property that's 20, 30, 50, or more years old. The record retention standard is 6 years and 3 months after DOD makes the last payment. We do not have documentation in many cases to meet the audit standards.

That doesn't mean we don't have control of the assets. It doesn't mean that we don't know where the assets are. But, from a financial management perspective, too often that information is not in our systems and we do not have a sufficient audit trail back to the actual documentation to meet current audit standards.

Mr. KUCINICH. Are you just being held to a higher standard and that is why you would get this report from the General Accounting Office which suggests that the audit condition of the Department of Defense is less than praiseworthy?

Mr. TOYE. The Department of Defense is not being held to a higher standard than any other agency in the Federal Government. I don't mean to imply that we are. What is true, though, is that we are being held to a standard today that we were not being held to in many instances when our current systems were developed. We need to do something about that.

We are doing something about that. We are upgrading our accounting systems to meet current standards, but it is going to take us some time to complete that effort.

Mr. KUCINICH. Is it unreasonable to ask for pieces of paper to be available to match physical equipment?

Mr. TOYE. If we're talking about a recent purchase, the Department of Defense should have, and I believe does have, adequate documentation to support that purchase. But if we're talking about a purchase that happened 20, 30, or 40 years ago, and many of the items in DOD's property records are that old, we simply do not have that documentation because in many instances, we have sent that documentation many years ago off to a records retention area and after a certain period of time those records have been destroyed.

Mr. KUCINICH. So then is the General Accounting Office's financial audit of the Department of Defense basically challenging you to do things that are impossible?

Mr. TOYE. What we needed to do, and what we have been doing, is working with the DOD IG, with the General Accounting Office, and with the Office of Management and Budget for the instances that I have mentioned to find if there is another test, reasonableness test, that can be applied that can satisfy the audit standards. We are still conducting those discussions.

We're still exploring ways that the auditors can verify the accuracy of our information if we cannot produce a receipt or a cost voucher for some of this older equipment or older property. And I'm hopeful that that process eventually will lead to a compromise where we can satisfy the auditors and they can be comfortable with the value that the Department of Defense has in its financial statements.

Mr. KUCINICH. If I may, the testimony by the GAO, and I quote, speaks of "serious material weaknesses were found in Department of Defense systems and processes relied on to maintain accountability and to control physical assets under its purview, including military equipment; general property, plant and equipment; and inventories." Those are to say, "Overall these problems impair DOD's ability to know the location and condition of all its assets, including those used for deployment; safeguard assets from physical deterioration, theft, or loss; prevent the purchase of assets already on hand; and determine the full costs of the programs that use these assets."

That is a direct quote from the General Accounting Office. And you are telling this committee that you do have control, you know where everything is, you just do not have the papers to prove it, or you have an accounting system that you cannot keep up with?

Mr. TOYE. I would say that is generally true. I certainly do not want to imply that there is no instance within DOD where an item might not be today where the property records say that it should be or it is. The Department of Defense is a very large organization; it has hundreds of thousands of items. On any given day it is quite possible that an item may not be—it is not only quite possible, it is very likely that some items will not be physically where the property records state that they should be. But what one needs to do in that instance is to inquire as to where the item is. That does not necessarily mean that the Department doesn't have control over that physical asset.

For example, a Humvee may be on the property records in property lot A, but one may go out there and look and not find that Humvee. It may well be that that Humvee is in the repair shop undergoing an overhaul. It may be, for whatever reason, it had to be pressed into service because another vehicle was not available.

So there certainly will be operational reasons in addition to the fact that in some instances the paperwork just may not have caught up with the physical transfer of an item. There are lots of reasons why the property records may not be 100 percent accurate. But I need to repeat, if I may, what——

Mr. KUCINICH. What they say, if I may, that they speak of—this GAO report speaks of material deficiencies, including Department of Defense's inability, and this is the top item, to properly account for and report billions of dollars of property equipment inventory and supplies.

Mr. Toye, you know, I take it that you are a fine public servant, and I appreciate your being here. What I am trying to determine here is, if there is just a lack of communication between your division and the GAO, or if in fact we have things that are missing or that we cannot find or that the Department is not sure of, where they are.

I mean, actually, if we have testimony by the GAO—and Mr. Chairman, you mentioned the helicopters where I think you mentioned 10 helicopters were, in effect—I think I remember the sense of it—that we had a duplicate purchase or something. Was that it, Mr. Chairman? Do you remember?

Mr. HORN. Not really. It is just missing for various reasons.

Mr. KUCINICH. It seems to me that there is a duplicate purchase. Now, if duplicate purchases occur, that means we did not know we had it and we bought it a second time. I just wonder what the problem is here, the nature of it, because we are talking about hundreds of billions of dollars of taxpayers' money. And I take you at your word.

Let me ask Mr. Lieberman or Mr. Warren to comment. Is this just really a question of missing paperwork? Is that what is going on? Do we just have a problem of missing paperwork here? Is that what this is all about?

Mr. LIEBERMAN. Well, we have several things intertwined in each other here. Let me see if I can work through a couple of them.

In some cases, yes, the property is properly controlled, but in a property book or in a logistics system. It is not lost. But the system is unable to tell the financial system that that item exists. From an audit standpoint, we can't go looking for millions of items in the Defense Department down to the unit level every year, nor can senior managers rely on information that's incomplete.

I think a telling example is the problem in the warehouses. We went out and did an inventory in 16 different DOD warehouse facilities. And now I'm not talking about end items like planes and trucks; I'm talking about truck batteries and flashlight batteries and screws and bolts and things like that. We found a 16-percent error rate in the inventory records of the warehouses, which was much higher than we expected.

Now, in terms of dollars——

Mr. KUCINICH. Is this missing paperwork? Are we finding actual, concrete errors?

Mr. LIEBERMAN. We go out and look at the inventory record. The warehouse thinks it has 100 truck batteries on the shelf. We go and count how many batteries are on the shelf and it is not 100. So the inventory record locally is wrong. Now, in many cases there are more batteries on the shelf than the inventory record indicates.

Mr. KUCINICH. Is that like Mr. Toye said, look, it is there. Is it there or is it not?

Mr. LIEBERMAN. It's there. Unfortunately, the item manager doesn't know it's there. When you have overages——

Mr. KUCINICH. Remember that song, "I hear music and there is no one there, I wonder why"?

Mr. LIEBERMAN. That's right.

Mr. KUCINICH. It is there, but we do not know it is there.

Mr. LIEBERMAN. If you have more items than are on the inventory record, that means they are not really controlled, and that means somebody can walk out the door with them tomorrow and no one will know that they are gone because they didn't know they were there in the first place. Conversely, when you have shortages and you don't know it, all of a sudden you will be unable to fill a requisition one day and you'll wonder why.

So this is down where the Department really operates on a day-to-day basis, filling supply requisitions and things like that, so it's not quite an arcane accounting drill back here in Washington that we're talking about. This does have practical world consequences.

Mr. KUCINICH. I've tried to, in my questioning here, avoid a he-said-she-said kind of thing, because frankly, we have two different views in accounting here. But I want to make sure that there is one view on accountability. There is accounting and then there is accountability, accountability meaning accountability to taxpayers of the United States of America.

So it appears that your statements in some ways can be reconciled, but at the same time I want to make sure there is a recognition that there are some physical problems in the system and that it is not simply a matter of a paper chase.

Do I capture that correctly, Mr. Lieberman?

Mr. LIEBERMAN. Yes. I think my good friend, Nelson, and I are closer on this issue than it may appear.

Mr. WARREN. I think we've hit on an important point. We really have two problems here. We have poor financial management data, but what we're also finding when we go to the theater systems that provide information for those financial reports, that we have poor day-to-day management information systems that support logistics managers. That is the situation. We've uncovered two deficiencies really as a result of this audit and this is work that we've done in the past.

Mr. KUCINICH. So this is not just a matter of things from 40 years ago. You are saying, it is ongoing problems?

Mr. WARREN. Particularly with regard to inventory. And that is why—and I think the Department would say they have an effort that Nelson referred to to be complete in the year 2000—they call it total asset visibility. The Department would like to get total asset visibility of all the assets that they own and they recognize that they desperately need to do that, and that's a management initiative in the logistics community so that they can operate in the same way that UPS does, for example.

Mr. KUCINICH. You know, I appreciate your dialog here because it helps us to better understand where you are coming from. And again, none of this is meant to construe on anyone's part here a lack of diligence. We recognize as the testimony of the Inspector General for the Department of Defense that there are some historic inadequacies in financial management. We also have an obligation to try to see, can we move from that paradigm to one in which we can have more assurance that the resources are being managed in a way that is responsible and that we can verify and account for them.

Mr. LIEBERMAN. Can I make one other quick point of clarification?

Mr. HORN. Sure. I'm going to pursue some of this anyhow. Go ahead.

Mr. LIEBERMAN. I can't really sit here and let the idea pass by that we're looking for 50-year old bills or receipts. We know that such things don't exist. The problem is to come up with some way of reliably estimating what these facilities are worth at the present time. And we are working very hard, as Nelson indicated, with GAO, OMB, and the Department in trying to figure out models to use.

There have been two attempts. Frankly, both have busted because we've tested the costs coming out of the model for example for a 50-year-old—I'll use warehouse again—against those warehouse facilities where we actually did have data and we know what they cost and stuff like that; and we had such wide variances that both models obviously didn't work. But we're going to keep trying because that's the only way out of this, other than just to write it off somehow as immaterial and get it out of the statements, which I don't think is a viable option.

Mr. KUCINICH. Thank you, Mr. Chairman.

Mr. HORN. Let me pursue some of this, because I am just curious what we are seeking in the financial accounting system. Are we seeking a separate system that simply lists inventory? Maybe you look at it as you would a capital budget in a corporation where certain things are above $2 million or something are considered one way, and all the little pieces and screwdrivers and all the rest of it are just a lump sum the other way. What are we trying to accomplish? Are we trying to just say, it's here? Or are we saying, well, what is the replacement cost on this and keeping updated on replacement in terms of the value that would be assigned to that particular item?

Who has got the answer to this as the best way to go about that?

Mr. TOYE. Mr. Chairman, from a financial statement perspective, the end result is to accurately reflect the dollar value in the financial statement.

Mr. HORN. And which dollar value are you taking, replacement cost, amortized cost?

Mr. TOYE. If we're talking property, the current standard asks us to use the historical cost. The instances that we've been talking about, where we're struggling, is where we don't have the records to demonstrate the historical cost. We may even have an entry into our records that tell us what the historical costs were at the time of purchase, but we are unable to support that with documentation to demonstrate that that number is indeed accurate. But the standard is historical cost, not replacement cost for property.

There are some exceptions. Inventory you have a choice, you can use historical costs or you can use the latest acquisition cost. But by and large, the property standard is the historical cost.

Mr. HORN. How is current acquisition cost any different from replacement cost?

Mr. TOYE. Some people might say that it is the same. The primary or technical difference might be that the latest acquisition cost is the last purchase. The replacement cost might be viewed as the price of the next purchase.

Mr. HORN. It seems to me you have to sort this into a number of different categories, just to make logical sense. If you are budgeting, that means we need to look at the replacement cost. If you are simply saying, this is the total value because we are running an accounting system, not an inventory system of 8,000 widgets here, we are putting a value on them. And the value, as you say, could be the historic cost. Frankly, it would mean nothing, in my humble opinion; I would not even look at an accounting sheet that way.

Unless it is land, I would want an auction to see what that land is worth. Because no appraiser would be able to go on a military base, like Fort Ord, and say, well, for seaside in Monterey we sell land for this maybe, but that is not what happened at Ford Ord. It is a university; it is a number of other nonprofits and so forth that are there.

So how do you really pick that cost? I will leave it to the accountants to worry about. But it seems to me, there has got to be some sensible system for the managers that are trying to manage the Department of Defense, and you want to know, what are my obligations down the line? How much is this going to cost me, if somebody is drunk at night and runs this contraption over a cliff? And we need to know, what is the experience? How many incidents like that have we had? How many things did we replace last year? That makes some sense to me in an accounting and budgeting system.

Also I would like to know, just on your computing side, to what degree between now and the year 2000 on both the 2000 problem and getting you to get a financial statement that makes sense—do we need replacements of hardware or is it simply software? Could you enlighten me on that?

Mr. TOYE. Yes, Mr. Chairman. I do need to say I couldn't agree with you more with regard to the accounting data as opposed to the budget data. The information in some cases is not the same. It should not be the same, and they are used for different purposes.

With regard to the computer issues, let's take the year 2000 issue first, if I may. In the financial world, the Department has identified those financial systems that are not year 2000 compliant and those that are compliant. The Department has a plan for making compliant those systems that are not compliant. It has a schedule to make those systems compliant. And I fully expect that the Department and the financial community will indeed make those systems compliant long before—I shouldn't say "long," but certainly before the year 2000.

With regard to your second question as relates to audited financial statements, the Department does not project at the current time that it will be able to modify all of its financial management systems by the year 2000. It will be beyond that before the Department can bring its accounting and finance systems into compliance with the current accounting requirements.

Mr. HORN. Now, is that effort headed basically by your shop, the Under Secretary for Comptroller/Chief——

Mr. TOYE. The Chief Financial Officer, the Under Secretary of Defense, Comptroller, Mr. Bill Lynn, is indeed responsible for ensuring that the financial management systems are brought into compliance. The Defense Finance and Accounting Service is the operating arm of the Comptroller organization that is actually doing the work.

Mr. HORN. Is there a plan where people are meeting weekly and making sure things are being done to conform to getting this thing implemented by the year 2000?

Mr. TOYE. Yes, there is. The Department has had a plan for a number of years, and at the direction of the Congress is currently doing another plan, a concept of operations, which will address system issues in more detail.

Mr. HORN. Let me ask you, is there any difference in the accounting systems used for the Active forces versus the Reserve forces both in terms of the methodology but also in the computers they have or do not have? In other words, have the Reserve forces been sort of given the leftovers of one generation and trying to keep track of their financial and inventory matters, contractual matters in any different way than the Active forces?

Mr. TOYE. I certainly wouldn't characterize the systems of the Reserve components as leftover systems.

Mr. HORN. No. I'm just saying, are there?

Mr. TOYE. As I indicated, earlier in 1991 we had 324 systems, each one of them different. We're now down to 156 finance and accounting systems, each one different. We are headed toward 32 systems as our objective. So the answer has to be, yes, the systems we have today are different, they operate on different hardware, they use different software. The idea is, when we perform similar functions to try to consolidate similar functions onto similar systems. We certainly are not there at this point in time.

Mr. HORN. Is there any comment any of the others of you want to make on what you have heard from the Department of Defense, any further comments from anybody? This is your last chance.

Yes, Ms. Jacobson.

Ms. JACOBSON. I would just emphasize that the logistics issue is a real issue of not having adequate visibility over the assets from a logistical standpoint and the financial accounting system. It is not a question of paperwork. The examples that we gave on CBXS, the Army's visibility system, their goal is to have 98 percent visibility of that equipment at all times. The work we did showed at a maximum they had 87 percent visibility over their assets. That's a 13 percent invisibility. And that means inefficiency as well.

So I would just say, it is not a question and I emphasize that it is not a question of paperwork, but is truly a question of whether they now know where their assets are and how many they have of these items.

Mr. HORN. Well, I guess I would need to know from Mr. Lynn and from Mr. Kaminski's shop, are you working together to get a common definition here, or has that already been decided and defined and set up so people have a goal, they know what to achieve?

Mr. TOYE. The Department has a number of initiatives under way. The Department fully recognizes that we cannot achieve auditable financial statements without closer working relationships between the financial management community and many other communities within DOD. One of the efforts that is ongoing within the Department is the standardization of data to ensure that when we say, A, we all understand that and all speak the same language and have the same interpretation of similar words.

So those efforts are under way within DOD, yes, sir.

Mr. HORN. Good. Anything you want to say about what anything else on the GAO, the IG's group, any comments you have?

Ms. Spector? I just want to make sure the dialog is out on the table.

Mr. TOYE. I would just like to say, Mr. Chairman, again just to reiterate, that I am an accountant. Financial management is important to me. I will indicate to you that I met with the Secretary of Defense earlier this week. The Secretary is interested in financial management. The Department takes this seriously. It has plans under way. It is not moving as quickly as others may want us to move. We're moving at a deliberate pace. It's a big organization. We take it seriously. We'll get the job done. It just will take some time.

Mr. HORN. Well, I appreciate that. And let me just say I want to thank each of you for coming.

I want to make a few announcements in closing.

Tomorrow we will continue our series of hearings on financial management in the Federal Government's executive branch, and at that will be the Social Security Administration, and we will be discussing how they have achieved their effective financial management in a lessons-learned type thing. They have been sort of at the

"A" level of all the things we have been grading on, including strategic plans, financial management plans, and so forth.

Next Tuesday, April 21st, is about the time of the 20th anniversary of the Inspector Generals; and we will be having a hearing with them and they will be presenting testimony on oversight as to whether the act under which they have existed now for two decades should be revised in any way.

Finally, next week, on Friday, April 24, we will be holding a joint hearing with two subcommittees, Health and Environment, and Oversight and Investigations, of the Committee on Commerce, with ourselves, looking at the Health Care Financing Administration's finances. We are going to see what HCFA is doing. And given the consolidated audit and balance sheet that they put out recently, the conclusions were drawn that there are about $20.3 billion in erroneous Medicare payments. So we will obviously be pursuing that.

I want to thank the staff that helped put together this hearing: J. Russell George, who is seated behind me, staff director and chief counsel; seated to my left, your right, Dianne Guensberg, detailee from the General Accounting Office; and, Pentagon, we welcome your detailees over here—we are not biased, but any experts, we are willing to tap their brains as long as you pay them—John Hynes, professional staff member; Matthew Ebert, clerk; Mason Alinger, staff assistant; David Coher, intern—this is his last hearing with us; he is going to go back to full-time study at USC. That is not the University of South Carolina, Easterners; that is the University of Southern California. And then Kami White, intern.

And then on the Democratic side we have Mark Stephenson, professional staff member. And Jean Gosa is their clerk. And then our faithful court reporters, who are tired of listening to all of this, I am sure, Ryan Jackson and Doreen Dotzler. We thank you all.

This subcommittee will be in recess until tomorrow morning.

[Whereupon, at 12:55 p.m., the subcommittee was adjourned, to reconvene on Tuesday, April 21, 1998.]

OVERSIGHT OF FINANCIAL MANAGEMENT PRACTICES AT THE SOCIAL SECURITY ADMINISTRATION

FRIDAY, APRIL 17, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Kucinich.

Staff present: J. Russell George, staff director and chief counsel; John Hynes, professional staff member; Matthew Ebert, clerk; and Faith Weiss and Julie Moses, minority professional staff members.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology, having adjourned yesterday afternoon, now reassembles for the third in a series of hearings that lead from the consolidated statement that was issued last week on the executive branch.

We are here today to discuss the status of financial management practices and information at the Social Security Administration. This is the fourth in a series of hearings looking at financial management in the executive branch of the Federal Government.

Two weeks ago, this subcommittee held a hearing on the first ever audit in the history of the country of the executive branch of the government. It was governmentwide. There were a couple of As given. There were a couple of Bs. There were no Cs. There were mostly Ds and Fs and incompletes, so we aren't done with the problem yet. But Social Security was the A type, and that is why we are glad to have them here this morning.

We have started exploring the status of financial management in various key agencies. On Wednesday, April 15, a day that shall go down in history for many of us, we looked at efforts under way to address management problems of the IRS, and we asked Commissioner Rossotti tough questions about the persistent technology problems that have plagued that agency.

As I was doing that, I was thinking how the Social Security Administration has been ahead of every other agency in this Government in terms of the year 2000 problem, where you are moving from the two-digit year that they dreamed up in the 1960's, when we were desperate for computer capacity, to the four-digit year, if we are not going to have absolute chaos on January 1st, 2000, and we congratulate this agency for doing it on your own initiative. Congress didn't have to tell you. The President didn't have to tell you. You did it because you knew what the implications would be, and all the other agencies can learn an awful lot from your experience.

Yesterday we discussed the need for remedial actions at the Department of Defense to correct longstanding and severe problems in achieving even the most basic level of fiscal accountability.

The Social Security Administration was the first agency to complete this year's audit. It was also one of the first agencies to have its financial statements audited under a pilot project back in 1990. In fiscal year 1997, the Social Security Administration received a clean opinion on its financial statements for the 4th year in a row.

The Social Security Administration has been able to provide timely and reliable information related to its financial operations, as we found in our hearing 2 weeks ago on the consolidated governmentwide financial statements of the executive branch. Indeed, that was no small feat.

I commend the Social Security Administration on its accomplishments. The audit report did specify two instances of noncompliance with laws and regulations. Despite the Social Security Administration's general success, we cannot ignore those issues.

This hearing will focus on lessons learned and best practices from the Social Security Administration that could assist other Federal agencies in financial management reform efforts.

The subcommittee is interested in the successful actions taken by the Social Security Administration to implement the Chief Financial Officer's Act, which grew out of this committee and is the law of the land. We are also interested in how the Social Security Administration is responding to compliance issues that have been raised in the auditor's reports, and we welcome the witnesses this morning to enlighten us on some of these subjects.

[The prepared statement of Hon. Stephen Horn follows:]

ONE HUNDRED FIFTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

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"Oversight of Financial Management Practices at the Social Security Administration"

April 17, 1998

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management, Information, and Technology

We are here today to discuss the status of financial management practices and information at the Social Security Administration. This is the fourth in a series of hearings looking at financial management in the Federal government. Two weeks ago this subcommittee held a hearing on the first-ever audit of the Government's consolidated governmentwide financial statements.

We then started exploring the status of financial management at key agencies. On Wednesday--April 15--we looked at efforts underway to address management problems at the Internal Revenue Service and asked the IRS Commissioner some tough questions about the persistent technology problems that have plagued the agency. Yesterday, we discussed the need for remedial actions at the Department of Defense to correct long-standing and severe problems in achieving even the most basic level of accountability.

The Social Security Administration was the first agency to complete this year's audit. Social Security was also one of the first agencies to have its financial statements audited under a pilot project in 1990. In fiscal year 1997, the Social Security Administration received a clean opinion on its financial statements for the fourth year in a row.

The Social Security Administration has been able to provide timely and reliable information related to its financial operations; as we found in our hearing two weeks ago on the consolidated governmentwide financial statements of the Federal Government, this is no small feat. I want to commend the Social Security Administration on its accomplishments. I should note, however, that the audit report noted two instances of noncompliance with laws and regulations. Despite the Social Security Administration's general success, we cannot ignore these issues.

This hearing will focus on lessons learned and best practices from the Social Security Administration that could assist other Federal agencies in financial management reform efforts. The subcommittee is interested in the actions taken by the Social Security Administration that enabled it to successfully implement the Chief Financial Officers Act. We also want to know how the Social Security Administration is responding to the compliance issues raised in the auditor's report.

We welcome the witnesses and look forward to their testimony.

Mr. HORN. I do not see the ranking member at this point, so we will go ahead and we will swear in the witnesses for the first panel.

We have Mr. Dyer here, the Acting Principal Deputy Commissioner, representing the Social Security Administration. We have David Williams, the Inspector General of the Social Security Administration. He is accompanied by Pamela Gardiner, the Assistant Inspector General for Audit. And Mr. Daniel Devlin, I believe, was going to be here. Is he here? Why don't you join us at the table, Deputy Assistant Inspector General for Audit.

If you will raise your right hands.

[Witnesses sworn.]

Mr. HORN. The clerk will note that all four witnesses have affirmed the oath.

We will proceed with the ranking person from the Social Security Administration, Mr. John R. Dyer.

Mr. Dyer, please proceed.

STATEMENT OF JOHN R. DYER, ACTING PRINCIPAL DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. DYER. Good morning, Mr. Chairman, and thank you and the members of your subcommittee for this opportunity to testify about the Social Security Administration's audited financial statement as contained in the Social Security Administration's Accountability Report for Fiscal Year 1997.

Let me briefly review SSA's financial position at the end of fiscal year 1997. For fiscal year 1997, the Statement of Financial Position reflects total assets of $649 billion, a 14 percent increase over the previous year. This increase is attributable to the steady growth of the Old Age, Survivors and Disability Insurance Trust Fund reserves, which were invested to generate $42 billion of interest income, an increase of $5 billion compared to fiscal year 1996.

The OASDI trust funds own 99 percent of SSA's assets, of which $631 billion are investments that are only converted to cash when needed to pay benefits and other expenses. Revenue and other financing sources increased by 7 percent to $481 billion in 1997. In 1997, the administrative expenses for all of SSA's programs only used 1.4 percent of our total revenue and financing resources. SSA is committed to efficiency and has been successful in directing most revenues to current and future beneficiaries.

Now let me provide some background and history on Social Security's audited financial statements and the Accountability Report. The Social Security Administration, as an agency, has been preparing audited financial statements on an annual basis since fiscal year 1987. Fiscal year 1997 represents the 4th consecutive year that SSA's financial statements have received an unqualified and clean audit opinion.

Our financial statements were prepared consistent with the requirements of the Federal Accounting Standards Advisory Board, the Office of Management and Budget, the Chief Financial Officers Act, and other relevant Federal statutes.

The Social Security Administration has also demonstrated its leadership in external reporting by participating as an Accountability Report pilot agency since fiscal year 1995.

In addition to audited financial statements, an accountability report consolidates the mandatory reporting requirements of the Chief Financial Officers' Act, Prompt Payment Act, Debt Collection Act, Federal Managers' Financial Integrity Act, and reports on numbers of financial program performance measures, in advance of the Government Performance and Results Act, GPRA, statutory deadlines, which help SSA's ability to achieve its strategic goals.

In cooperation with our Office of Inspector General, beginning in fiscal year 1996, the Accountability Report incorporated the Inspector General's Semiannual Report to the Congress. In addition to the complete discussion of management's activities for the year, the Accountability Report also provides a summary of significant audit and investigative work accomplished by the Inspector General.

We are currently the only Federal agency to incorporate this reporting requirement into the Accountability Report. Not only are SSA's financial statements and accountability reports financially sound and comprehensive, they are also timely.

SSA's Fiscal Year 1997 Accountability Report was issued on November 21, 1997, only 52 days following the close of the fiscal year. In issuing the report so timely, SSA's report was the only one issued early enough to be considered in developing the President's fiscal year 1999 budget.

The Accountability Report serves many customers both outside and within SSA. We view this document as an important vehicle to share the information with the taxpayers and beneficiaries, which in turn helps build confidence in the Social Security program by assuring the public that taxpayer dollars are managed wisely. We proudly post this report on the Internet and have distributed nearly 2,000 hard copies to date.

However, the information contained in the Accountability Report is not just compiled at the year end for reporting purposes. To make use on a day-to-day basis of the information gathered for the Accountability Report, SSA has developed a powerful tool to disseminate information to executives and managers, the Executive and Management Information System, or as we refer to it, EMIS. EMIS is available to SSA executives on our intranet and is updated monthly. This system tracks current year workload processing against both stated current year goals and prior year processing for many common workloads; for example, the number of disability claims processed in total and by region and by State.

This type of performance measure system is vital in the shift from managing resources to managing for results as the Results Act and other recent legislation require. The key performance measures of SSA's annual performance plan which support our strategic goals are closely monitored through the EMIS. In fact, our executives meet monthly to review the agency's key initiatives, goals and objectives, using the performance information disseminated through EMIS. This constant monitoring is necessary to ensure management is aware of any performance trends before compilation of the Accountability Report.

Building on the success of previous audits conducted by the Office of the Inspector General, we expanded the scope of our fiscal year 1997 financial statement audit by contracting to have Price Waterhouse, under the Inspector General oversight, audit our financial statements, systems of internal control and compliance with laws and regulations. This expanded effort gives greater assurance that SSA is being managed both efficiently and effectively. In addition to the clean opinion we received on our fiscal year 1997 financial statements, Price Waterhouse also determined that SSA's systems of accounting and internal control were in compliance with the internal control objectives of the Office of Management and Budget Bulletin 93–06 in all material respects.

Price Waterhouse's expanded scope resulted in suggestions to improve SSA's internal control structure in areas such as protecting information, continuity of operations, software development, separation of duties, and quality control. We have already taken corrective action on many recommendations and are continuing an open and honest dialog with Price Waterhouse and the Inspector General to discuss additional actions to further strengthen our internal control structure.

Mr. Chairman, SSA wants to make it clear that nothing is more important in operating our programs than ensuring that the public has confidence in us when it comes to information that is placed in our trust. We will do whatever is necessary to assure this subcommittee and the American people that SSA's stewardship over their personal information and financial assets is beyond reproach.

As you can see, we are working with the auditors to address their recommendations. I expect to have most implemented by July 31. We do not view this as a completed product, though. As history shows, we are continuing to improve our operations and are fully prepared to meet any new challenges which may arise. We appreciate the support provided by your subcommittee in particular, the Congress in general, and I would be happy to answer any of your questions. Thank you, Mr. Chairman.

Mr. HORN. We appreciate that statement.

[The prepared statement of Mr. Dyer follows:]

Thank you Mr. Chairman and Members of the Subcommittee for this opportunity to testify about the Social Security Administration's (SSA) audited financial statement as contained in SSA's Accountability Report for Fiscal Year (FY) 1997.

Let me briefly review SSA's financial position at the end of Fiscal Year 1997. For FY 1997, the Statement of Financial Position reflects total assets of $649 billion, a 14 percent increase over the previous year. This increase is attributable to the steady growth of the Old Age, Survivors, and Disability Insurance (OASDI) Trust Fund reserves which were invested to generate $42 billion of interest income, an increase of $5 billion compared to FY 1996. The OASDI Trust Funds own 99 percent of SSA's assets of which $631 billion are investments that are only converted to cash when needed to pay benefits and other expenses. Revenues and other financing sources increased by 7 percent to $481 billion. In FY 1997, administrative expenses for all SSA programs only used 1.4 percent of our total revenue and financing sources. SSA is committed to efficiency and has been successful in directing most revenues to current and future beneficiaries.

Now, let me provide some background and history on SSA's audited financial statements and the Accountability Report. On April 1, 1998, this Subcommittee held a hearing on the Consolidated financial statements of the federal government for Fiscal Year 1997 which was prepared by the Department of the Treasury. This was the first such government-wide financial statement ever prepared. In perspective, the Social Security Administration, as an agency, has been preparing audited financial statements on an annual basis since Fiscal Year 1987. Fiscal Year 1997 represents the fourth consecutive year that SSA's financial statements have received an unqualified, or clean, audit opinion. Our financial statements were prepared consistent with requirements of the Federal Accounting Standards Advisory Board, the Office of Management and Budget, the Chief Financial Officers' Act and other relevant Federal statutes.

The Social Security Administration has also demonstrated its leadership in external reporting by participating as an Accountability Report pilot agency since Fiscal Year 1995. In addition to audited financial statements, an Accountability Report consolidates the mandatory reporting requirements of the Chief Financial Officers' Act, Prompt Payment Act, Debt Collection Act, Federal Managers' Financial Integrity Act and reports on a number of financial and program performance measures (in advance of Government Performance and Results Act (GPRA) statutory deadlines) which help assess SSA's ability to achieve its strategic goals.

In cooperation with our Office of Inspector General and beginning in Fiscal Year 1996, the Accountability Report incorporated the Inspector General's Semiannual

Report to the Congress. In addition to the complete discussion of management's activities for the year, the Accountability Report also provides a summary of the significant audit and investigative work accomplished by the Inspector General. We are currently the only Federal agency to incorporate this reporting requirement into the Accountability Report.

Not only are SSA's financial statements and Accountability Report financially sound and comprehensive; they are also timely. SSA's FY 1997 Accountability Report was issued on November 21, 1997, only 52 days following the close of the fiscal year. In issuing the report so timely, SSA's report was the only one issued early enough to be considered in developing the FY 1999 President's Budget.

The Accountability Report serves many customers both outside and within SSA. We view this document as an important vehicle to share information with taxpayers and beneficiaries which in turn helps build confidence in the Social Security program by assuring the public that taxpayer dollars are managed wisely. We proudly post this report on the Internet and have also distributed nearly 2,000 hard copies to date. However, the information contained in the Accountability Report is not just compiled at year end for reporting purposes. To make use, on a day-to-day basis, of the information gathered for the Accountability Report, SSA has developed a powerful tool to disseminate information to executives and managers, the Executive and Management Information System or EMIS.

While the information contained in the Accountability Report can be viewed as the top of the information pyramid, EMIS contains the raw baseline data, broken into more manageable pieces, used to make daily decisions. EMIS is available to SSA executives on our Intranet and is updated monthly. This system tracks current year workload processing against both stated current year goals and prior year processing for many common workloads, for example the number of disability claims processed in total and by region. So if the number of claims processed in a region deviated significantly from the prior year, management can ask the questions necessary to uncover the reasons and, if necessary, quickly take appropriate action. This type of performance measurement system is vital in the shift from managing resources to managing for results as the Results Act and other legislation requires.

The key performance measures from SSA's Annual Performance Plan which support our strategic goals are closely monitored through the EMIS. In fact, our executives meet monthly to review the Agency's key initiatives, goals and objectives using the performance information disseminated through EMIS. This constant monitoring is necessary to ensure management is aware of any performance trends before compilation of the Accountability Report.

We at SSA recognize the importance of the Social Security program to every American, and we strive not only to meet legislative requirements but exceed them. In our continuing effort to improve our operations and build public confidence, working with the Congress, we have increased Inspector General resources thus helping ensure that every dollar entering the trust funds is used to pay the correct benefit amount and administer the program as efficiently as possible.

Building on the success of previous audits conducted by the Office of Inspector General, we expanded the scope of our Fiscal Year 1997 financial statement audit by contracting to have Price Waterhouse, under Inspector General oversight, audit our financial statements, system of internal controls and compliance with laws and regulations. This expanded effort gives greater assurance that SSA is being managed both efficiently and effectively. In addition to the clean opinion we received on our Fiscal Year 1997 financial statements, Price Waterhouse also determined that SSA's systems of accounting and internal controls were in compliance with internal control objectives in Office of Management and Budget Bulletin 93-06 in all material respects.

Price Waterhouse's expanded scope resulted in suggestions to improve SSA's internal control structure in areas such as protecting information, continuity of operations, software development, separation of duties and quality control. We have already taken corrective action on many recommendations and are continuing an open and honest dialog with Price Waterhouse and the Inspector General to discuss additional actions to further strengthen our internal control structure.

Mr. Chairman, SSA wants to make it clear that nothing is more important in operating our programs than ensuring that the public has confidence in us when it comes to information that is placed in our trust. We will do whatever is necessary to assure this Subcommittee and the American people that SSA's stewardship over their personal information and financial assets is beyond reproach. As you can see we are working with the auditors to address their recommendations. I expect to have most implemented by July 31. But we do not view this as a completed product. As history shows, we are continuing to improve our operations and are fully prepared to meet any new challenges which may arise. We appreciate the support provided by your Subcommittee in particular and Congress in general. I would be happy to answer any of your questions.

Mr. HORN. I now call on the Inspector General of Social Security, David Williams.

Mr. Williams.

STATEMENT OF DAVID C. WILLIAMS, INSPECTOR GENERAL, SOCIAL SECURITY ADMINISTRATION, ACCOMPANIED BY PAMELA GARDINER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, SOCIAL SECURITY ADMINISTRATION; AND DANIEL R. DEVLIN, DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDIT, SOCIAL SECURITY ADMINISTRATION

Mr. WILLIAMS. Chairman Horn and Mr. Kucinich, thank you for the opportunity to appear here today to discuss the recent audit of the Social Security Administration's financial statements.

The Chief Financial Officers Act of 1990 requires the Inspector General or an independent auditor named by the Inspector General to audit SSA's financial statements. This annual review serves three purposes. It contributes to the increased public confidence in Social Security by attesting to the accountability of its resources. It identifies significant problems in SSA's control systems and recommends corrective actions. And it aids congressional oversight by showing areas where Congress can work with SSA to improve the Social Security system.

Although this is the 11th year SSA has been producing audited financial statements, it was the first year an independent public accounting firm was hired to conduct the audit. The Office of Inspector General contracted with the IPA firm Price Waterhouse to conduct the audit. The IPA conducted the audit efficiently, effectively and in a short timeframe. I believe the IPA was able to conduct this audit so efficiently because of three factors. SSA's accounting function and management systems are centralized; there was a beneficial knowledge base from the previous years' financial audits; and the IPA had demonstrated expertise in areas covered by the audit.

SSA's accounting and financial management functions are centralized, and the primary source of SSA's accounting data is internal. SSA's national computer center serves as its central data processing center by controlling all of the application systems that are used by facilities nationwide. This centralized structure combined with an internal source of accounting data provides for the efficient use of audit resources because it allows auditors to focus on one location.

The IPA assigned 90 auditors whose expertise was in financial and systems auditing to conduct this audit. Because SSA's centralized accounting function has not changed significantly over the last 11 years, the auditors were able to rely on previous assessments to identify high-risk areas and plan sufficient audit coverage to review those areas.

The IPA gave SSA's financial statements an unqualified opinion. An unqualified opinion represents an assurance that the financial statements and related accounting systems are free from material error and generally comply with significant laws and regulations.

The IPA also found five significant deficiencies in SSA's general controls environment. These deficiencies undermine the overall integrity of elements of the data processed through SSA's automated systems. Specifically the IPA found that SSA needs to improve controls to protect its information; improve and fully test its plan for maintaining continuity of operations; improve its software applications development and change control policies on procedures; improve controls over insufficient separation of duties; and improve quality control activities.

The IPA cited concerns or instances of noncompliance with the Federal Financial Management Improvement Act and recommended that the first four of the deficiencies be reported as material weaknesses under the Federal Managers' Financial Integrity Act of 1982. Citing the limited details in the first report, SSA stated that it was unable to fully respond to these deficiencies. After receiving two subsequent management letters, SSA was better informed on the basis of these problems and agreed to take action on most of the IPA's recommendations. In keeping with SSA's goal of rebuilding public confidence, the Commissioner made resolving the IPAs findings as a top priority.

Another of the agency's priorities is the implementation of the Government Performance and Results Act, which contains a requirement to improve the confidence of the American people by holding Federal agencies accountable for achieving program results. In fulfilling this priority, SSA faces several challenges.

SSA must develop new ways of measuring the financial cost of its programs, which is in an integral part of measuring performance. Accurately measuring the true cost of its operations is a significant challenge to SSA because of standing concerns with its existing cost accounting system and the increased expectations contained in the new cost accounting standards that were recently issued by the Joint Financial Management Improvement Program. By implementing the managerial cost accounting standards, SSA can provide adequate, timely information on the full cost of its programs.

In conclusion, I believe this audit was successful on two fronts. First, it revealed specific areas where SSA needs to strengthen its financial management. Second, it gave SSA, Congress, and the public a better awareness of the adequacy of SSA's stewardship. I believe the successes of this audit will contribute to improving the oversight and operations of SSA. Thank you.

Mr. HORN. We thank you. That was a very helpful statement, and we will get into it more in the question period.

[The prepared statement of Mr. Williams follows:]

Chairman Horn and members of the Subcommittee, thank you for the opportunity to appear here today to discuss the recent audit of the Social Security Administration's (SSA) financial statements.

The Chief Financial Officers Act of 1990 requires that the Inspector General (IG) or an independent auditor named by the IG audit SSA's financial statements. This annual review serves three purposes: (1) it contributes to increased public confidence in Social Security by attesting to the accountability of its resources, (2) it identifies significant problems in SSA's control systems and recommends corrective actions, and (3) it aids congressional oversight by showing areas where Congress can work with SSA to improve the Social Security system.

Although this is the ninth year SSA has been producing audited financial statements, it was the first year an Independent Public Accounting (IPA) firm was hired to conduct the audit. The Office of the Inspector General contracted with the IPA firm Price Waterhouse to conduct the audit. The IPA conducted the audit efficiently, effectively, and in a short time frame. I believe the IPA was able to conduct this audit so efficiently because of three factors: (1) SSA's accounting function and management systems are centralized; (2) there was a beneficial knowledge base from the previous years' financial audits; and (3) the IPA had a demonstrated expertise in the areas covered by the audit.

SSA's accounting and financial management functions are centralized, and the primary source of SSA's accounting data is internal. SSA's National Computer Center serves as SSA's central data processing center by controlling all of the application systems that are used by SSA facilities nationwide. This centralized structure combined with an internal source of accounting data provides for an efficient use of audit resources because it allows auditors to focus many of their resources on one location.

The IPA assigned 90 auditors whose expertise was in financial and systems auditing to conduct this audit. Because SSA's centralized accounting function has not changed significantly over the last 9 years, the auditors were able to rely on previous assessments to identify high-risk areas and plan sufficient audit coverage to review those areas.

The IPA gave SSA's financial statements an unqualified opinion. An unqualified opinion represents an assurance that the financial statements and related accounting systems are free from material error and generally comply with significant laws and regulations. The IPA also found five significant deficiencies in SSA's general controls environment. These deficiencies undermine the overall integrity of elements of the data processed through SSA's automated systems. Specifically, the IPA found that SSA needs to

- improve controls to protect its information,
- improve and fully test its plan for maintaining continuity of operations,
- improve its software application development and change control policies and procedures,
- improve controls over insufficient separation of duties, and
- improve quality control activities.

The IPA cited concerns or instances of noncompliance with the Federal Financial Management Improvement Act and recommended that the first four of these deficiencies be reported as material weaknesses under the Federal Managers' Financial Integrity Act of 1982.

Citing the limited details in the first report, SSA stated that it was unable to fully respond to these deficiencies. After receiving the two subsequent Management Letters, SSA was better informed of the basis of these problems and agreed to take action on most of the IPA's recommendations. In keeping with SSA's goal of rebuilding public confidence, the Commissioner made resolving the IPA's findings a top priority.

Another of the Agency's priorities is the implementation of the Government Performance and Results Act, which contains a requirement to improve the confidence of the American people by holding Federal agencies accountable for achieving program results. In fulfilling this priority, SSA faces several challenges.

SSA must develop new ways of measuring the financial cost of its programs, which is an integral part of measuring performance. Accurately measuring the true cost of its operations is a significant challenge to SSA because of standing concerns with its existing cost accounting system and the increased expectations contained in the new cost accounting standards that were recently issued by the Joint Financial Management Improvement Program. By implementing managerial cost accounting standards, SSA can provide adequate, timely information on the full cost of its programs.

In conclusion, I believe this audit was successful on two fronts. First, it revealed specific areas where SSA needs to strengthen its financial management, and second, it gave SSA, Congress, and the public a better awareness of the adequacy of SSA's stewardship. I believe the successes in this audit will contribute to improving the oversight and operations of SSA.

Mr. HORN. Ms. Gardiner, do you have anything to add to that at this point?

Ms. GARDINER. No.

Mr. HORN. Mr. Devlin?

Mr. DEVLIN. No, sir.

Mr. HORN. Fine. Then let's go to questions.

As part of the fiscal year 1997 audit that Price Waterhouse did, where they reported those significant deficiencies in the area of information protection, what steps has the Social Security Administration taken or plans to take to alleviate the concerns raised by the outside public audit regarding unauthorized access to sensitive data, and how much of a problem is it for you, and do you have a way of measuring that? And let me throw one more factor out. Have you built firewalls within the computer system so they can't completely destroy your records in different areas, such as that?

Mr. DYER. Mr. Chairman, let me start out by saying that, when Price Waterhouse did its testing of us on access to our data, they were not able to penetrate our systems, and that reassures us that we have the data and the privacy information of our beneficiaries protected.

Mr. HORN. May I say at that point, do they have any nerds out of the local high school? I mean, if these are people that are used to computing, that is one thing, but hackers are a breed unto themselves.

Mr. DYER. Mr. Chairman, we hire outside consulting groups and experts to try to penetrate us. We are constantly maintaining and updating. As you know, dealing with nerds and hackers is a never-ending business, and I lose sleep at night thinking about it. As you know, there is always someone trying to figure out how to get in. We have an internal program that is designed to constantly update us and keep us beyond hopefully even the state-of-the-art.

Responding to your question of what they did find, though, is they did find that the way we did have our security set up, that we didn't have all our software and all our programs that we should have, and it wasn't integrated. So we are now moving to make sure we do integrate all the security and all the systems across various other programs that we do not have covered.

There were also questions about the security of some modems that we had that we should not have had, and we have been in the process of rapidly removing the modems in question. So we have been responding very quickly to these findings. Anything that anybody identifies that threatens the security of our data bases, we jump on as fast as we can.

Mr. HORN. Can someone get into one of your files, one of the many tens of millions, and change the data that makes them eligible for Social Security?

Mr. DYER. The only people who can do that are our employees who are authorized to do so.

Mr. HORN. Do you know of any time files have been tampered with?

Mr. DYER. I am not aware of any time we have been penetrated by the outside.

Mr. HORN. How about the Inspector General, do you know if you have been penetrated?

Mr. WILLIAMS. That is our understanding as well, Mr. Chairman. And as Mr. Dyer said, the agency has been contracting for some time their own people to try to penetrate the system, and although we had confidence in them, we felt that an independent firm, such as Price Waterhouse, should give it a last check. So this was not the first effort to patrol this important area, and I know it won't be the last.

Mr. HORN. Let me get on the record Ms. Gardiner and Mr. Devlin. Do you have any knowledge of penetration of Social Security files by anybody outside the agency?

Ms. GARDINER. No, sir.

Mr. DEVLIN. No, sir.

Mr. HORN. OK. So you haven't seen any files that have been tampered with?

Mr. DYER. And we hope never to.

Mr. HORN. Well, that is amazing. The Pentagon has difficulty. Maybe we should send your team over there and help them. They are getting about as much money as you are, but we will take a look at that one a little further anyhow.

What worries me, I have seen this happen to credit bureaus and credit data and other types like that, and I think the average citizen simply wants to have some assurance that those files are secured. As you know, increasingly, whether the government likes it or not, or we like it or not, the Social Security number is an identifier for practically everything that happens in this society. Students are registered in universities that way. Many States require them, I think, for voting registration. Many of them have other uses for it, in terms of the driver's license and so forth, and all the credit cards floating around. You never know what has been taken off your credit card once you hand it to the intermediary to pay your bill in millions of places around the world. So that, I think, worries the average citizen. I am glad to hear your reassurance on that, that you have never had an incident of anybody getting through into your system to do damage to it or damage to the individuals who are part of that system.

Mr. DYER. We think it is very important that we do everything possible to prevent any unauthorized persons from accessing our data bases.

Mr. HORN. Well, I am delighted to hear that, but I want to know if there has ever been any incident, and I have four witnesses under oath saying there never has been.

Now, during 1997, current and former recipients owed the Social Security Administration more than $2.6 billion, including $1 billion in newly detected overpayments for the year. What additional procedures can the Social Security Administration implement to prevent and detect fraudulent payments for the Supplemental Social Security Income Program?

Mr. DYER. Mr. Chairman, you are referring to the billion dollars or so that was identified for the Supplemental Security Income Program where we have an annual debt?

Mr. HORN. That is correct.

Mr. DYER. We are putting together a plan to improve the management of the Social Security program which will address a lot of the issues that have been raised and brought to our attention.

Mr. HORN. Why don't you explain for the record, because I think the average person in Congress as well as the average citizen isn't aware of the unique relationship that the supplemental Security Income Program has, who administers it and what the role of Social Security is.

Mr. DYER. The Supplemental Security Income Program will spend about $28 billion, if I remember right, this year and the money predominantly goes to low-income elderly and disabled persons. It was originally created as a supplement so that the elderly, who would not have enough money to get them out of the poverty level with just the basic Social Security retirement, could have the difference, and over the years it has been expanded to cover a large portion of our disabled population who really need the resources to live and survive on. There are about 6 million people currently receiving Supplemental Security Income payments.

Mr. HORN. Now is there an estimate by the Inspector General as to the degree to which fraud occurs in this program, and, if so, what is the typical type of case that is considered fraudulent?

Mr. WILLIAMS. This has been a very old problem in identifying the universe of fraud, not just for Social Security, but for the entire law enforcement community. We don't have a sense as to the entire universe of fraud that exists. We do know the amount we are able to tap into. We have the largest hotline operation in the United States, and that provides us with a lot of good intelligence.

We also study very closely the operations that we execute in different varieties of fraud to try to understand how prevalent the levels of fraud are. And the levels that we are encountering are the levels that you would expect to find for a cash benefit type of program.

Mr. HORN. What is that particular level that you feel we should find?

Mr. WILLIAMS. Could you be more specific?

Mr. HORN. Is it 10 percent, 20 percent, 30 percent?

Mr. WILLIAMS. That's the figure that has sort of always eluded law enforcement.

Mr. HORN. Which one? I gave three.

Mr. WILLIAMS. The ability to assign a percentage to what we don't know. We have never been able to do a good job of that, and we are sort of in the boat with Customs and the DEA and everyone else.

Mr. HORN. You don't like those figures. Are they in error?

Mr. WILLIAMS. The percentages you suggested?

Mr. HORN. I said is it 10 percent fraud, is it 20 percent fraud, or is it 30 percent fraud, or higher?

Mr. WILLIAMS. We know the numbers that we are finding. The mystery is the numbers that are out there that we have not detected, so that is what gives me the level of discomfort in supporting any of those figures or in attacking any of those figures.

Mr. HORN. What are you finding?

Mr. WILLIAMS. We have about 18,000 reports last year of fraud within our various programs. And as you said, identity theft is a very troubling area involving misuse of the Social Security numbers. Smaller levels are found within the SSA program.

Mr. HORN. Well, what programs that you administer have the most fraud in it, in the number of cases, and then which has the highest percentage?

Mr. WILLIAMS. The SSI program has the highest percentage of fraud, as far as just the broad numbers.

Mr. HORN. What is that percentage?

Mr. WILLIAMS. Well, again, of the 18,000, I am sorry—we do have the percentages of that. Of the 18,000 complaints we received—and I would like to provide a more precise number for the record, but it seems to me that it's at about 20 percent of all the allegations we receive.

Mr. HORN. Let me make sure I understand this. You have 18,000 possible fraud cases. These have been through the hotline, you stated?

Mr. WILLIAMS. Yes, sir.

Mr. HORN. By and large. And the 18,000 are not limited to SSI; that is all of the Social Security Administration, or is it limited to SSI?

Mr. WILLIAMS. It's all three of our major programs.

Mr. HORN. Why don't you say what the other two are.

Mr. WILLIAMS. The identity theft, misuse of the——

Mr. HORN. No, you say all three of your programs.

Mr. WILLIAMS. Yes, that is one of the investigative programs. We have misuse of the Social Security number, the second one is SSI, and the third one is Social Security retirement programs.

Mr. HORN. Why don't you go through those and say what is a typical example of the type of fraud within each of the three programs.

Mr. WILLIAMS. In the Social Security program, as I said, they are low, but sort of persistent levels of fraud.

Mr. HORN. This is SSI or Social Security retirement?

Mr. WILLIAMS. This is Social Security retirement, sir.

Mr. HORN. That is your basic program, isn't it?

Mr. WILLIAMS. It's certainly the largest with regard to the dollars.

Mr. HORN. So you have how many people, roughly, in the Social Security retirement program?

Mr. WILLIAMS. I am going to ask John to help me.

Mr. DYER. It is about 43 million.

Mr. HORN. 43 million. OK. And out of that, you then have—can you allocate that 18,000—coming over the hotline, I mean, was this 4,000 that are Social Security retirees or what; do we know?

Mr. WILLIAMS. We do know, and I apologize for not having it handy with me, and we will provide it for the record, but I will tell you what we believe is roughly correct. I believe it's roughly at the 10 percent level.

[The information referred to follows:]

Social Security Administration's Fraud Hotline

The Social Security Administration's (SSA) Fraud Hotline opened on November 25, 1996 and has grown to be one of the largest in Government. The Hotline is the focal point for allegations regarding fraud, waste and abuse in the programs and operations of the Agency. In Fiscal Year (FY) 1997, the Hotline received an average of 1,500 allegations per month. Of those, approximately 550 were referred to the Office of Investigations for action; 375 were referred to SSA for administrative processing, and of the remaining 575 there was either not enough information to warrant any type of action or no violation. However, all allegations are logged into the Allegation Management Division's data base in case further information becomes available.

We receive allegations from numerous sources which include: private citizens (39 percent), anonymous callers (34 percent), SSA employees (12 percent), Public Agencies (6 percent), beneficiaries (4 percent), Federal Law Enforcement (3 percent), and other (2 percent).

We break out our allegations of fraud by program (RSI, DI, and SSI) as well as SSN fraud Employees fraud and others. In FY 1997 allegations of program fraud received by the Hotline averaged 745 per month (300 allegations against DI, 291 against SSI, and 154 against RSI). The majority of allegations concern Social Security Number fraud. In FY 1997, we received an average of 655 allegations regarding SSN fraud per month.

Mr. HORN. Fifteen percent?

Mr. WILLIAMS. Of all of our allegations.

Mr. HORN. Well, 15 percent of 43 million functioning cases? You have a very anxious person back here on your staff that is getting nervous about it. So why don't you consult and see what the answer is.

Mr. WILLIAMS. Judy Chesser wanted me to reinforce that of the allegations we receive, not of the 44 million recipients, but of the allegations we receive, about 18 percent deal with Social Security.

Mr. HORN. In other words, of the 18,000 potential fraud cases——

Mr. WILLIAMS. Exactly.

Mr. HORN [continuing.] Ten percent of 18,000, which is the Social Security retirement program, which is your largest program, 43 million, that's the possible apportionment, and you will file the rest for the record. Can you file it for some of the past years, if you have kept that for the record? Is this an increase in a number of cases. With a hotline, obviously, you should get a few more cases than doing nothing about it.

Mr. WILLIAMS. These are fairly stable figures that I am giving you.

Mr. HORN. OK.

Mr. WILLIAMS. The SSI program is at about 20 percent, I think; I said 25 a moment ago. And the retaining percentages, which I think are 60 percent, involve identity theft.

Mr. HORN. Is that illegal aliens, essentially?

Mr. WILLIAMS. That is a common example, but there are also people engaged in bank fraud and credit card fraud that are also involved in the misuse of the Social Security number. There are also a very wide-ranging variety number of other crimes, including terrorism. Anyone who needs a false identity to perpetuate a crime in this modern age of commerce must have a Social Security number.

Mr. HORN. Well, have you had a chance in past years to identify what type of identity misuse has occurred, and have you got some classifications within that basic area?

Mr. WILLIAMS. I believe that we do, sir. I don't have those with me.

Mr. HORN. Does any of your staff have it? It seems to me that is just basic data that, if the Commissioner is awake, he or she should be asking about it.

Mr. WILLIAMS. Within the subcategory of Social Security number fraud, we do have that data. I was just conferring with my investigative chief. I am not sure we have that—I think you wanted a further breakdown of identity theft.

Mr. HORN. I mean, that is a very large category. You are saying—are the 18,000 cases to which you refer simply in this current fiscal year?

Mr. WILLIAMS. Yes, for fiscal year 1997, they are.

Mr. HORN. What were the cases in the previous fiscal year on fraud?

Mr. WILLIAMS. Our hotline has been growing. The proportions have been about the same, but the numbers have been growing as our hotline came on stream.

Mr. HORN. When did you first establish the hotline?

Mr. WILLIAMS. It was November 25, 1996, sir.

Mr. HORN. So we have at least, then, 3 years of data. Is this a fiscal year or a calendar year; how are you keeping it?

Mr. WILLIAMS. We keep it by fiscal year, sir.

Mr. HORN. That runs from essentially October 1 of one year to September 30, the next, the Federal fiscal year, which is probably known nowhere else in the United States. We thought, when we passed all these bills earlier, and then later and later, why, gee, let's change the fiscal year to October 1st; we are always done by that time. Now we are not done by that time either, so we have probably a slippery fiscal year in order to make up not just for a day every 4 years in leap year, but a leap year, in reality.

I would like the breakdown of what you have got in terms of what you found over the 1995 fiscal year, which would have ended at midnight on September 30, 1995; and then we have 1996, 1997, and we are in 1998. So we have got 3 years of data here somehow, depending on when that started. I would like Social Security to give us a breakdown. How many cases, what did it eventually show, were they half legitimate? Because people can phone up and say crazy things about anybody in America. People faithfully write that down sometimes and put it in a file, which proves to be very harmful to citizens that have not done anything except upset some grumpy old neighbor that wants to get even with them.

I think it worries all of us in government, when government files can be penetrated. We are going to hold a hearing again on medical confidentiality, which knows errors of unbelievable violations of people's privacy and confidentiality, but we will get to that in a couple weeks. And we are working on it for 2 years behind the hearing scene. But this is what bothers me is in 1995, 1996, 1997, did you have about the same number of calls, like 18,000?

Mr. WILLIAMS. No.

Mr. HORN. You didn't?

Mr. WILLIAMS. We didn't. My concern, though, is I am afraid the reason for that, the intervening variable, was we were just beginning our operation; we are a new Office of Inspector General, so that has been growing. But I believe the reason is more that we have been advertising and making the public aware that we are available.

Mr. HORN. Now, how do you advertise that so they know there is a hotline?

Mr. WILLIAMS. We have a hotline poster with detailed information that we put in the Social Security offices, and then on our reports that number is contained.

Mr. HORN. What do you do in terms of just notifying the Social Security recipient when a check goes out? It seems to me I would put a little sheet right in that—it's issued by the Treasury, isn't it; the financial management service, a very fine organization in my opinion—I would just put a little slip in there, like your friendly city puts it in, on all the good things they are doing, or here is a summary of the budget. Have we done that, to put it in with the checks?

Mr. WILLIAMS. We have not done that.

Mr. HORN. Well let's do it, OK. I mean, there are 43 million people that could be Ambassadors for you to tell the whole world about the hotline when they go to the next senior citizen meeting or the Grey Panthers or whatever, or the senior nutrition program. This is a chance to get 43 million people working for you because, believe me, they will have a lot of stories to tell. Some might be inaccurate. Most of them are going to be accurate. People aren't stupid; they see this stuff all around them. They say, I worked year after year after year to get Social Security credit and here is this bozo that is into the Social Security and the money I have put in, because of fraudulent use of a card. And you would be amazed how many helpers you get. If you wanted to give them some of the finder's fee, boy, that is great with Congress. Let's get them to be a few bounty hunters like the 19th century or something and maybe we will clean up this operation.

So give me, then, off the top of your head, the staff or whoever, if you have these cases; and this is the high, I take it, 18,000 so far this year?

Mr. WILLIAMS. It is the high. And as you said, those are the allegations, from those reopening, a smaller number of investigations.

Mr. HORN. How does that work and who does the investigations; the Inspector General, your shop, or is there a separate investigations shop?

Mr. WILLIAMS. We have the investigative organization for the agency. The way those are decided is we do a kind of triage operation on the allegation. As you said, we have to be somewhat suspect of certain of the allegations, and we divide those with the agency. In some of the instances, it alleges the kind of allegation that would be best managed by the agency in terms of terminating the payment. Others clearly indicate intention and criminal behavior, and we take those.

Mr. HORN. I am sure my colleague will have plenty of questions to ask. If you think I have been difficult, wait until you hear him. He will pursue it with his fine legal mind.

Mr. WILLIAMS. I appreciate your interest.

Mr. HORN. I will leave to my colleague what he wants to do there. Twenty-one minutes to the distinguished Member from Ohio.

Mr. KUCINICH. Thank you very much, Chairman Horn. And I want to thank the Chair for this series of oversight hearings which we have been conducting in the last week.

I think the hearing on Tuesday, when we looked at IRS' financial management weaknesses, and certainly the hearing yesterday about the Department of Defense, which gave all of us pause about financial management there—we come to this today and I think we have to say, Mr. Chairman, this is a bright spot, and it truly is, in the Federal financial audit process. So the Social Security Administration from the outset ought to be congratulated for the manner in which you faithfully administer hundreds of billions of funds and investments in this country.

As the people know, the SSA manages the Social Security Trust Fund and pays Social Security benefits. When you look at the enormity of the work you are involved in, I think it's $350 billion in annual payments to 50 million Americans. They process 225 million wage and tax statements each year for 138 million workers.

You have 1,300 field offices, 8 processing centers, 10 regional centers and you employ over 65,000 people. I mean, this is a major service, a major service of the Federal Government. And I think the attention of the Nation, when it's directed to the Social Security, people always want to know how solid is that system and how is it run.

So what is brought to us today, I think, is a financial success story, and it is very good that you received that clean opinion from Price Waterhouse.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Opening Statement of The Honorable Dennis Kucinich
GMIT Hearing: Social Security Administration's Financial Management
April 17, 1998

This hearing is the third in a series of oversight hearings on the financial management of particular Federal agencies. On Wednesday, we looked at weaknesses in the IRS financial accounting practices, and yesterday, we reviewed problems at the Department of Defense. Today, we will focus on one of the bright spots in the Federal financial audit process -- the Social Security Administration.

SSA manages the Social Security Trust Fund and pays Social Security benefits. It also runs the Supplemental Security Income ("SSI") program. In total, SSA issues over $350 billion in annual payments to 50 million Americans and processes 225 million wage and tax statements each year for 138 million workers. It operates 1,300 field offices, 8 processing centers, 10 regional centers, and headquarter's offices, employing over 65,000 people.

SSA represents a financial management success story. The agency received a clean audit opinion from Price Waterhouse, its independent financial auditor, on both its financial statements and its assurances of internal system controls.

What's more. SSA's audit was completed on time.

I am heartened to hear that such an important agency can report both reliable financial information and adequate internal controls over that information.

As we will hear. SSA still has a few areas of concern relating primarily to information processing and security. The auditors issued 160 specific recommendations to SSA. The agency agrees with 90% of these recommendations and is currently taking action. One important message to take from this hearing is that these independent audits are valuable, because they raise both accounting and information processing issues to management's attention.

SSA has identified $1 billion in Supplemental Security Income ("SSI") overpayments this year and is developing a management plan to reduce these overpayments. SSI overpayments are generally not attributable to fraud or mismanagement, but rather result from delays in voluntary reporting of changed circumstances by SSI recipients. Although SSA recoups about 40% of its SSI overpayments, that still leaves about $600 million uncollected each year.

I would like to welcome the witnesses who are here to discuss the audit and the financial condition of SSA. Both the agency and its auditors deserve congratulations for a job well done. SSA proves that Federal agencies can implement management systems capable of generating reliable financial reports.

As we review its successes, we should not forget that SSA, like most other Federal agencies, still faces the challenge of applying future cost accounting standards. This is the next step and will indeed be difficult.

Mr. KUCINICH. I would like to go into, first, the structure of SSA's financial position, as you reported it, Mr. Dyer, in his remarks. The total assets now are at 649 billion; is that right?

Mr. DYER. Yes, sir.

Mr. KUCINICH. And they increased 14 percent over the previous year. So would you tell us how that increase came about?

Mr. DYER. Because we had additional revenues coming in is basically the reason.

Mr. KUCINICH. And the revenues came from?

Mr. DYER. From the FICA taxes. And interest; excuse me, I forgot we had interest we picked up, too. The FICA taxes we collect on an annual basis.

Mr. KUCINICH. FICA?

Mr. DYER. The taxes you pay for your Social Security retirement. And on an annual basis, the amount we have coming in is exceeding the amount we have going out, this year by about $80 billion.

Mr. KUCINICH. So how much more money came in this year, total, from FICA? What were the numbers?

Mr. DYER. Over what the outgo was, about $80 billion. Excuse me; that will be for this fiscal year.

Mr. KUCINICH. What was the amount of FICA that came in, though?

Mr. DYER. Let me give you an exact number here. The receipts were for the fiscal year—excuse me, sir. I keep moving from 1998 to 1997 here; $405 billion was what came in in revenue.

Mr. KUCINICH. $405 billion dollars. And then your—the money that you spent——

Mr. DYER. We spent for OASI, the retirement piece, $312.9 billion.

Mr. KUCINICH. So that establishes the amount of money you have in surplus, then.

Mr. DYER. That is right, sir.

Mr. KUCINICH. So that equals a little more than a billion a week, is it?

Mr. DYER. About $1½ billion a week.

Mr. KUCINICH. OK. Thank you.

Now the Old Age Survivors and Disability Insurance Trust Fund reserves. You have in your statement that the amount that was invested generated $42 billion of interest income. When you use the word "invested," where are you investing?

Mr. DYER. We have them in Treasury securities.

Mr. KUCINICH. Talk about the Treasury securities for a minute.

Mr. DYER. Under the way the statute is currently set up, any funds we have coming in that exceed outgo—they go in, as we call it, our reserve—are invested in Treasury securities; and Treasury turns around and pays us interest while we have those funds invested with them. And as you can see, we have over $600 billion currently invested in those securities.

Mr. KUCINICH. That is the so-called Social Security Trust Fund?

Mr. DYER. Reserve; yes, sir.

Mr. KUCINICH. Reserve. So there are $600——

Mr. DYER. Over $600 billion.

Mr. KUCINICH. Over $600 billion.

What rate of interest does that earn?

Mr. DYER. If I remember, it is about 7 percent. It goes up and down over the years, historically. It has been up to 11 or 12 percent; I think we are sometimes down to 5 percent, depending on what the overall interest rate is.

Mr. KUCINICH. It stays well ahead of inflation, I take it?

Mr. DYER. That's right. Right now they are telling me 6.7 percent at this point.

Mr. KUCINICH. The Social Security Trust Fund, the fund is set up in such a way as to—your legal mandate is to put the money into Treasury?

Mr. DYER. Yes, sir.

Mr. KUCINICH. What are the Treasury instruments they are put in in terms of length of time?

Mr. DYER. What they refer to as special obligations for the trust funds.

Mr. KUCINICH. And what length of time are they put in?

Mr. DYER. They vary. I am trying to remember.

Mr. KUCINICH. Is it 3 months, 6 months, a year; what?

Mr. DYER. I think they are a 10-year range.

Mr. KUCINICH. Ten-year. And those funds are backed up by the full faith and credit of the United States of America; right?

Mr. DYER. Yes, sir.

Mr. KUCINICH. Is there anything more solid in the world than that?

Mr. DYER. Not that I'm aware of.

Mr. KUCINICH. So the money which people pay through their taxes, the Social Security, is then invested; it's in a trust fund, it's secured; it's invested, in effect, in the United States.

Mr. DYER. Yes, sir.

Mr. KUCINICH. The trust fund is secured by the full faith and credit of the United States, and people can rely on that. It is rock solid; is that what you are telling me?

Mr. DYER. Yes, sir.

Mr. KUCINICH. And now you have an independent financial audit that says the money is being managed correctly and the money that we say is there is there.

Mr. DYER. Yes, sir.

Mr. KUCINICH. In your remarks, you mention that the—what is called the OASDI, Old Age Survivors and Disability Insurance Trust Fund, owns 99 percent of the Social Security Administration's assets, and that $631 billion are investments and you convert them to cash when they are needed to pay the benefits and the expenses. Let's talk about the mechanism of that. When claims are made to pay out, you have to pay something out, how soon after the claim is made is a payment made, after an obligation is incurred?

Mr. DYER. It's immediate. I mean, as soon as the start of the month, the check day, as we refer to it, the third day of the month is that, the minute that the check is there, it's immediate and it's charged off against us. The money is there to be paid out. On average, we find that people usually cash the check in 3 to 5 days.

Mr. KUCINICH. That is what I wanted to get at. In other words, the Government isn't holding onto people's money; there is no float.

Mr. DYER. No; none whatsoever.

Mr. KUCINICH. Where you are trying to back up the amount of money Government makes on that. You pay the money quickly, and it's——

Mr. DYER. Immediately. And, Mr. Congressman, not only that, but now with the direct deposit program we have, a large majority of our beneficiaries get their benefits directly deposited in their account immediately. It's sent electronically through the Federal Reserve.

Mr. KUCINICH. OK. So when they are returned back after their cash, are they usually cashed within a few days?

Mr. DYER. Yes, sir.

Mr. KUCINICH. Do you have many people call you and tell you they don't get their checks? Does that happen often?

Mr. DYER. Every month we have a certain number of people who call and say they didn't receive a check. Some checks end up being delayed in the mail, others were lost, others were stolen. And that is why we are encouraging people to go to direct deposit to get around that.

Mr. KUCINICH. So when people don't get their checks, they are either delayed in the mail or lost or stolen.

Mr. DYER. Or stolen.

Mr. KUCINICH. What is your advice to people, Social Security recipients, if they don't get their checks? What do you tell them to do?

Mr. DYER. Our advice to them, if they call us immediately, is usually that we will make sure we aren't aware of something that got delayed in the mail or whatever. But normally, if it's immediately on the same day, we will say wait a day and get back to us. If it goes past a day, then we start to followup. If they need emergency payment, we work out with them to get an emergency payment.

Mr. KUCINICH. How serious of a problem is theft of Social Security checks?

Mr. DYER. My memory, and again I will get the facts, I think it's about 50,000 a month.

Mr. KUCINICH. Out of?

Mr. DYER. Out of 50 million checks that go out totally, if you include the SSI program.

Mr. KUCINICH. How successful is the administration in tracking down those who are responsible for stealing checks?

Mr. DYER. We are very aggressive. Again, our responsibility is somewhat limited. We rely on the Postal Service and obviously Treasury and other parts of the Government to track down checks. It's mostly done through Treasury.

Mr. KUCINICH. I want to go back to your testimony.

The testimony speaks, again, of the trust funds, the OASDI, that own 99 percent of the assets, of which $631 billion are investments. Those investments, again, are the ones that are in the special Treasury.

Mr. DYER. Bonds and securities.

Mr. KUCINICH. Is that what you call them, bonds?

Mr. DYER. Bonds is fine.

Mr. KUCINICH. And you convert them to cash when you pay the benefits. Now, you also said that revenues and other financing sources increase by 7 percent. Those revenues again are the revenues from the——

Mr. DYER. Predominantly from where people pay for their taxes.

Mr. KUCINICH. What are the other financing sources?

Mr. DYER. We get some general fund revenue; the Supplemental Security program is funded from the general funds, so there is some money there we have carrying over year to year.

We also get some general funds of the taxes on the retirement money people get. Some of that tax is given to us under a statute that was passed in 1983, in the act to make reforms of Social Security back in 1983, so we do have some other sources that come in on the general revenue side of the house.

Mr. KUCINICH. I note that the administrative expenses for all of the Social Security programs are at 1.4 percent of total revenue in financing. Tell me what goes into those administrative expenses.

Mr. DYER. Basically, the day-to-day running of the organization. As was mentioned before, we have field offices and processing centers. We have approximately 65,000 employees, other State employees that help us; and we use those funds to get the checks out, to issue people their Social Security numbers, to answer telephone inquiries over our 800 number, to run our financial systems, run our data computer centers, and handle phone bills. All of that will be covered. Over two-thirds of our expenses are salary and payroll and the other third falls into maintenance types of things.

Mr. KUCINICH. I would like to go back to a question about the yield on the investments. What has been the average yield over the past 10 years, let's say? Do you know off the top of your head?

Mr. DYER. Nine percent.

Mr. KUCINICH. Nine percent over the past 10 years.

Has there ever been a time in your memory where Social Security recipients had their benefits cut because the trust fund didn't perform?

Mr. DYER. No.

Mr. KUCINICH. It doesn't happen?

Mr. DYER. It doesn't happen.

Mr. KUCINICH. Because the money is invested in the United States of America, backed by the full faith and credit of the United States of America.

Mr. DYER. Yes, sir.

Mr. KUCINICH. You know, Mr. Chairman, it's interesting to hear this testimony, for a number of reasons. First of all, because I am sure all of us have constituents who want to be assured of how solid that fund is, and that is something that—it's part of a covenant, really; it's a social compact which the Government has with the American people.

But in listening to this testimony, what strikes me is this. First of all, you have a 9 percent yield, average, over the last 10 years and a solid investment. There is no float going on here, the Government isn't holding onto the money, they are turning it around as quickly as possible, so the Government isn't trying to make more money while people lose money not getting their payments; and that the administrative expenses are extremely low.

At some point, I know, this Congress is going to get into a debate about those who wish to privatize the Social Security system, and it occurs to me in hearing this report today about this money that really is held literally in trust, that the American people have a good investment here; that it is solid; that it's being watched very carefully; that the administrative expenses are low.

I don't know anything in the private sector that could beat that claim when you look at, let's say, the administrative expenses that are happening now in certain health care and health management companies in the private sector. They are in the double digits. People are raking millions and hundreds of millions in profits, individuals, at the expense of patients involved in a health care system. And the management costs are out of sight. And yet, here you have administrative expenses of 1.4 percent. Why? Because this isn't a private entity making a profit; this is the U.S. Government holding people's money in trust and gaining interest on it in a fully secured investment.

We don't see when the stock reports are given daily, advanced decline is unchanged—where somebody adds a disclaimer and says well, stocks went down today; you are not going to get the money back you invested in Social Security. U.S. investment is solid. And I am very impressed when I hear this report from the Social Security Administration about its finances, because this is a cardinal principle of the American government that we make sure that we secure the retirement of our people. And the only way you can do that is to make sure it's managed correctly. If financial management is not sound, then we can't be sure that people's security in their senior years, or if they are disabled, is going to be intact.

So this is an important moment, I think, to hear from you and to get the assurance of how rock-solid this program is, and to know that this is one of the important functions of the government. And it works. It works.

And I have a couple other questions here, but you know, just responding to this report, I would have to say that I, as one Member of Congress in this committee, I am satisfied that you are watching not only the taxpayers' money, but the money in this trust fund.

I want to get back to some questions that Mr. Horn asked about the overpayments.

What do you do to try to decrease the overpayments in the future of the SSI in particular?

Mr. DYER. We have been putting a plan together to manage the SSI program better, because we see the issue to be more than just overpayments. It is a complex program, both for our people to manage and for our beneficiaries to understand. Areas we are aiming to improve are expanding computer matching, making them more frequent; broadening the areas with computer matching, because we found we have overpayments because we lagged behind finding people who had wage changes or forgot to report something. We found with increasing computer matches, we can get there.

We are working at training our employees better so when someone comes through the door, our employees know what kind of information to dig for, what to alert them for, or if they are getting all the information they should be getting.

We want to strengthen some of our debt collection activities. We have been using the tax refund offset program through Treasury, and we have collected over $20 million from folks that are getting tax returns that owe us on SSI, and we have been recovering that money.

In the fraud area with the Inspector General, we have been increasing and expanding the size of SSA's Inspector General's Office. We have been putting more investigators out on the street in communities, and we have been working closely with the Inspector General to target areas we think are most susceptible for fraud. We found, for instance, in border areas of the country, people don't quite tell us what their residency is, and they are living outside of the country and collecting SSI. Thanks to the good work of the Inspector General, we have been jumping on those kinds of issues.

We have also initiated an expanded program to make sure we track down all prisoners. We now get virtually 100 percent reporting on every prisoner in this country sentenced to over 30 days' detention, so that we are able to cutoff their benefits as soon as it comes to our attention. We can do this largely through matching. Congress has given us the bounty program through SSI, and that is very effective. We have sent $4 million now to local prisons to date on that, and we just got started.

Another area we are looking at is nursing homes. Once someone enters a nursing home, what we pay drops down to a very small amount, if any, and we are working now with HCFA so that we can get data quicker, so when people enter nursing programs, we can target in and find that out and cutoff SSI payments if it's appropriate.

Thanks to the help of the Congress, we are increasing the number of continuing disability reviews [CDRs] we are doing. In the past, we were only doing a couple hundred thousand annually. This year we will do over 1.2 million. In essence, we go out and review the records of people who are currently on disability, who we think there is a chance that maybe they have gotten well or something, or that their circumstances have changed.

We have also asked the Congress to give us additional funds and authority so we can do more redeterminations. This is where we actually review the financial status of people receiving SSI benefits. And we have several other areas and initiatives we are going to be pursuing aggressively.

Mr. KUCINICH. Just a quick question, which I will get back to in the next round to Mr. Williams.

Do you actually analyze the software that Social Security Administration uses as to its efficacy in both handling the massive number of accounts and in its overall effect on financial management?

Mr. WILLIAMS. If I may, I would like to get some of the other people at the table involved who are closer to that question, and we can tell you the degree to which we examine the software.

Ms. GARDINER. To a large extent we look at the process that they use to update their software rather than to really analyze the software ourselves.

We look at the results of what the software produces. If we believe that there are certain aspects of the program where there should be edit checks we review it to ensure that the software is catching errors. As an example, someone files a disability claim, and their date of birth is after that date, so we will look at those kinds of aspects of the software to ensure that it is catching things that it should.

We also look at the process that they use to change the software to make sure that it has proper controls, and that software can't be released without the right controls in place to ensure that it is accurate.

We also look at the process that they use to determine if there is any more timely way that they can update their software.

Mr. WILLIAMS. We are also present at key testing events along with the agency. We try to independently assess the manner in which the test proceeds and the success or problems in the testing.

Mr. KUCINICH. Mr. Chairman, if we can have one more round at least?

Mr. HORN. Yes.

Mr. KUCINICH. In the next round I want to get into some of the finer points on software and hardware. Thanks.

Mr. HORN. I think on some of the discussion as to the Trust Fund and as to the use of Government bonds, we will have a special hearing with my colleague and others on the Treasury coming in here, because you have no control over day-to-day market operations, as I remember. That's the function of the Secretary of the Treasury, or if they are involved with the Federal Reserve in some way. So we will have a hearing in the next few months to get at how these large trust funds are managed.

The point here is not privatization, the point is does the person that has put hard-earned money, and half of that payment comes from the employee and the employer, as they look at it, it is the whole payment because they are paying a particular wage of which roughly 15 percent is taken out, half and half employer and employee, and I think that has been a very good model. The question is are the recipients of Social Security getting as much money as they should get if funds were properly invested? That's the question.

You go to Chile, everybody has a passbook in their hand. I don't know if that is a good system or a bad system, I don't have the slightest idea, but I know that we are going to have a national debate on this to educate people. We don't want screwy investments that involve somebody playing games like in the S&L days, but we want to see if that interest that is in your consolidated financial statement, about $40-some billion, wasn't it, that you are getting in interest there, is the best we can do.

If you are in the State Employees Retirement Program, as I am in California, it is an unbelievable success. They are into the market. If they don't like management, their votes sure count on throwing them out, and the result is free health care is provided for retirees and all the rest of it. I think that is the issue that will be looked at.

Is there more that can be done if we get off from a somewhat antiquated way? Although I agree completely with my colleagues that Government bonds should be the last thing that we have a problem with. When the market goes down, Government bonds generally go up, and we just need to look at how judgments are made by the Treasury because they have a tremendous impact on your operation. Unless we are just sitting there saying, oh, well, Government bonds seem to be doing better than the market. I agree. Full faith and credit in the United States is behind them. We want to keep it that way. On the other hand, we want to look at the options and have an intelligent discussion and not a bunch of demagoguery like in the past when this discussion came up. What are the needs?

I know hundreds of people on Social Security. They get $500 a month. Now, how do you live on $500 a month in southern California, in New York, in the great urban cities of America? It's not easy, and we want to make sure that the $500 is there, but it would be nice if we could make sure that interest is also getting a better return for its dollars than perhaps it is getting. But that isn't your area, that's the Treasury's area, and we will work with them and with you to look at the whole picture.

Let me get back to these three categories. I want to systematically get at this. We talked about the SSI—I'm sorry, the large Social Security Retirement Program, we are talking 43 million people, and you are saying roughly 18 percent of the hotline tips or the written tips that come to you, and I assume you are including everything?

Mr. WILLIAMS. We are including Internet and faxes.

Mr. HORN. The total was about 18,000, and was that the last fiscal year? Is that fiscal year 1997's data?

Mr. WILLIAMS. Yes, sir, that is, and I'm told that is a fairly stable number for the current period as well.

Mr. HORN. OK. Then you have well, I have got this figure a little off here.

Are you saying 18 percent of the 43 million would be the figure on where possible misuse is or alleged misuse, because you haven't completed analysis of the claims, although you have 1995 data, and I guess I could ask you to what extent did you produce—how much from fraudulent claims in 1995 among the large retiree population?

Mr. WILLIAMS. If I may, these percentages I'm giving you as you said regard the allegations that arise, certainly not all the 44 million people, of the allegations we receive, about 10 percent regard the Social Security program, 20 percent regard the SSI program, and 44 percent regard misuse of the numbers for criminal purposes.

Mr. HORN. Right.

Has that been pretty consistent as you look at the 1995 data and the 1996 data, and we haven't got—well, I guess that is 1997 data. Has that been a fairly consistent proportion?

Mr. WILLIAMS. Yes, sir.

Mr. HORN. Well, explain to me how the State disability program does. You fund it, and the States administer it. To what extent does that program have particular fraudulent aspects?

Mr. WILLIAMS. Of course we have a disability program within Social Security and within SSI. The administration of those we were encountering the same sorts of things. The administration is fairly good, but we have numbers of allegations that come in. Those are our highest dollar losses because the payments are more substantial, and now they are over a long period of time as well.

What we have encountered there is it is a bit higher as well in SSI as opposed to disability claims within SSA. Actually, this is going back to a question that you asked a little earlier. The type of frauds that we are encountering on the SSI side involve both eligibility kinds of issues, income as well as fraudulent claims of fraud.

We have found that in the more than 2 years I have been at SSA, that the State DDSs, who make the determinations on eligibility, are very vigilant. They do a very good job. Their instincts are good because of the referrals. As you said, the quality is very high from both the public and the DDSs.

We just began an operation called Operation Contender in which we are sending investigative units inside the DDSs to watch suspicious cases as they pass by. We know that the early findings are that there are claimants that are committing fraud. What we really hope to find are the service providers the doctors and attorneys that may be involved.

All of that is going to give us greater intelligence to answer the kinds of questions that you are getting to, which are the most important. We want to know how hard we are getting hit and how we are getting hit. We are watching the operations both to try to arrest people, but also to understand the issue.

Mr. HORN. I was particularly pleased to hear your favorable comments in terms of electronic direct deposit. There is no question it helps cutoff the local gang from taking Aunt Minnie's $500 check out of the box because they know when the checks arrive. That was a major problem, and I never could understand why the AARP fought against that. I don't know if they have changed their position or not, but it was counter to the good welfare of the average citizen to get that check in the bank without a lot of hands touching it, which is what happens on the postal box situation. I have some horrible cases, every Congressman does in their district office, where the check has disappeared, we are phoning you. Your people, by the way, are very good on their legislative relations in the field. The Laguna Nigel group couldn't be better.

Those are the helpful hints that we all get out of them, and the helpfulness, and that means a lot to those individuals. They can't afford to miss a payment if they are still paying on a mortgage or whatever.

Mr. WILLIAMS. That's true.

Mr. HORN. Although I have heard on the year 2000 problem, the Social Security Administration has realized recently that their State disability program hasn't quite been in conformity now. I don't know if you are aware of how that is coming along or what.

Mr. DYER. I would be glad to address that, Mr. Chairman. We have a plan in place that we are working with the State agencies that by the end of this calendar year, we will have them in compliance with the year 2000. Twenty-one States to date already are compliant, and the rest are in process. We have a group working with the States and with our systems people who are focused on this. I'm reported to on how it is going on a monthly basis, if not more frequently. It looks like it is under control, and we are comfortable.

Mr. HORN. On the collection rate on the debt, what is the collection rate on the debt that results from detected overpayment, say, in the Supplemental Security Income program? Where are we on that? If there is an overpayment, do we get back half of them, a fourth of them, or two-thirds?

Mr. DYER. I don't have handy the data for SSI, but overall the percent of debt collected was 38.9 percent of the total debt, 38.9 percent. If you look at the amount of debt that we identify and overall how much clearance we have had in the financial statement of SSI, we identify about $1 billion, and we are clearing about $800 million, and so we are behind what's coming through, and we are putting in a lot of actions to start to address this.

Mr. HORN. Is a lot of that debt on the overpayment based on the earnings limitation?

Mr. DYER. Some is. Others are based on financial assets that people have that we weren't aware of or that they maybe forgot to tell us. In other areas it is just a misunderstanding. People's living arrangements change. Returning to work, people start getting money, and they sometimes forget to tell us.

Mr. HORN. Does "living arrangement" include marriage or not marriage? Is Social Security keeping people apart?

Mr. DYER. We try not to.

Mr. HORN. That earning limitation has annoyed me.

Mr. DYER. We look at ourselves as a family protection program, not a disruptive program.

Mr. HORN. The earnings limitation has annoyed me for 40 years, and I'm glad to say that Congress is finally phasing it out and getting rid of it. I never understood why Congress put it in in the 1930's. We should be encouraging people to work and still collect their Social Security based on when they put it into the system. We should keep people moving, get the brain working, and not just sit around watching television. The earnings limitation is just counterproductive to human beings who age successfully. They keep themselves busy, and yet we are saying that you can't earn a minimum wage even if it is beyond that. That bothers me, and I'm glad that Congress is finally making some progress in this area and getting rid of it. It is going to take a few more years before we completely get rid of it, but it is a phaseout, if I remember.

Mr. DYER. I think it is 2002 we get to $30,000.

Mr. HORN. So the good news is that we will get rid of that immediately.

In the Office's response to the Price Waterhouse audit, the Social Security Administration indicated it did not have sufficient information to respond to specific recommendations. Has SSA received sufficient information at this point to fully respond to the auditor's recommendations, and are the auditors comfortable with the agency's action plan?

Mr. WILLIAMS. I can tell you the last thing first.

As we pointed out, there were five deficiencies that were found and we were certainly in agreement with. We have been through the first two of those, and there has been a very high level of consensus with regard to the solution on those. As Mr. Dyer said, we hope by July it will all be completed, and between now and then we will learn about the agency's response on the final three—and I'm sorry to have gone first.

Mr. DYER. I thought he was directing it to you, so I always defer to the IG.

In terms of responding to Price Waterhouse, we have done it in two phases, Mr. Chairman. There were two recommendations on protection of data and continuity of operations. We received from Price Waterhouse earlier their management report and the background. There were over some 60 recommendations, and right now there are only two that remain unresolved, and they are not that major in terms of our materiality and whatnot.

Mr. HORN. What are the two?

Mr. DYER. One is that they recommended that when someone—when one of our employees enters our data security center, that we should make them go through an x-ray machine. We think that they should be checked, their passes checked. They are ID'd. They have security codes to get access and go into the building, and we checked with the Justice Department and GSA standards, and they don't require using metal detectors for entering if you have an employee ID. Obviously someone from the outside coming in, we would take them through it and search them thoroughly.

Mr. HORN. Is their concern based on the unfortunate shootings that have occurred particularly in the Post Office and other Federal agencies where someone fires somebody who has been incompetent for years, and they finally fire them, and then they come back and kill the supervisor; is that their worry?

Mr. DYER. No, they are worried more when a data security center is sabotaged, that someone could enter——

Mr. HORN. With a magnet?

Mr. DYER [continuing]. Or start a fire, place a bomb and destroy all of the records and valuables and the computers. Our computer center is worth a fortune and houses a lot of data. We obviously have backup, but we treat it with tremendous security. But it is a secured site. But that is one——

Mr. HORN. I think that is pretty good advice on the part of the auditors. I feel better when I am on an airplane every weekend to Long Beach, CA—that we have all gone through that security system.

Now if somebody is sort of dating the other security person, and they are making eyes at each other and not watching the screen, we worry about that, but they have improved that. I think the fact that people are not carrying guns or bombs on the plane makes a lot of us feel very good.

I would think in a big agency such as yours—I don't know, have you had any of these shooting the supervisor bits in——

Mr. DYER. Not shooting supervisors directly, but we have had times when the office has been held hostage, our supervisors have been held at gunpoint by people upset about something.

Mr. HORN. Were they upset about a Social Security issue?

Mr. DYER. Sometimes it is not a Social Security issue, they are upset or having domestic problems, and a member of the family comes looking for an employee. I'm not aware that we have actually had an employee pull a gun on a supervisor, but I'm not going to trust my memory on that. We do have incidents. And in higher risk offices we do use metal detectors.

Mr. HORN. Are you familiar with the Federal workers' compensation program administered by the Department of Labor?

Mr. WILLIAMS. A little bit.

Mr. HORN. Was that ever considered to be part of the Social Security Administration?

Mr. DYER. No.

Mr. HORN. Never was, so it predates Social Security, does it?

Mr. DYER. It was in the original act, but we were not given the job of administering it.

Mr. HORN. Because we will be holding hearings on that program in the next 6 months. We have been concerned with all the complaints we have heard about it. I warned the previous Secretary, Mr. Reich, I said, you might want to clean it up before we get there and get some things on the table.

It seems to me you do a lot of that work all the time in terms of disabilities. I don't know why we have other programs that don't do it as well as you do it, and maybe that's a possible option. I know you aren't anxious to grab any more territory, but maybe for the good of the cause you might want to think about it.

The Office of the Inspector General has been responsible for auditing SSA's financial statements since the fiscal year 1987, as I remember it. In what areas of financial management does your office believe the agency has made substantial progress? Where is the most substantial progress?

Mr. WILLIAMS. I would like to ask the people at the table to join me. We have examined areas that are sort of on point for the continuum of concerns. We have looked at physical security and systems security, and we can provide you with all that, separation of duties and backup and recovery systems that Mr. Dyer was alluding to earlier and the change of controls. We are a fairly new office. We are only 2 years old, and those other audits predated our existence, but I would like Mr. Devlin to respond regarding progress.

Mr. DEVLIN. In the most recent years I think the biggest contribution is the presentation of the financial statements as it relates to estimating the amount that is owed back to the Social Security Administration. There was a long process where the balance for the accounts receivable was not auditable. Since that time SSA has implemented a progressive system to put into place a better means for identifying amounts due back and to presenting an accurate auditable balance on the financial statements. For the longest time that was a condition that prevented us from expressing a clean opinion on the financial statements. Since that time we can now audit that balance, and that, to my knowledge, is probably the last piece that got us to the clean opinion.

Mr. WILLIAMS. The agency has also made very impressive progress during the short time I have been there with regard to being very aggressive toward fraud, and actually Mr. Dyer who is here was probably the most important figure in that. There have been tremendous increases in the amount of arrests and indictments and dollars recovered, and it is in the hundreds of percent increase since I've been there. And there is a very close—the closest I have ever seen, and I have been at a number of agencies—the relationship between the agency and the investigators to make sure that is a seamless attack on fraud, and I have been very impressed, and Mr. Dyer is certainly one of the very important reasons for that.

Mr. HORN. Well, I think he appreciates it, and I appreciated it.

What areas of financial management does your office believe that the agency still needs to address?

Mr. DEVLIN. There is an area that relates to financial management that's not immediately evident on the financial statements, and it has to do with developing an adequate cost accounting system, and the Inspector General alluded to that in his testimony.

The ability to be able to estimate and actually quantify the cost of delivering government services and at the same time capture and measure the related effect, the benefit, requires an accounting system that the Social Security Administration currently has, but has been identified as an area that really needs a good look. The General Accounting Office worked with the firm of Price Waterhouse to look at the existing cost accounting system and found that it's 20 years old, that it is labor-intensive. It rests upon methodologies and assumptions that haven't been looked at for quite some time. We think that may be an indication of other areas of financial management that aren't necessarily immediately evident in the financial statements that really do need a good strong look as the agency starts to look at the eventual implementation down the road of the Government Performance and Results Act.

So I would say cost accounting is——

Mr. WILLIAMS. To build on that for a moment, if I may.

Mr. HORN. Sure.

Mr. WILLIAMS. Government thinking did a 180 on that a few years back. It was considered the most economical strategy to combine all of the costs and to not go into the trouble and the labor intensity of tracking each program. We now understand that you cannot get a good feel for the return on investment and whether or not you want to expand or cutoff investments without that kind of data, so the entire government is trying to catch up in this area, and we are such a big agency that although we are taking it very seriously, and I think we will be successful, I would agree that is the greatest challenge that faces us financially.

Mr. HORN. Well, I have overextended my time. I will yield 25 minutes to the gentleman from Ohio.

Mr. KUCINICH. Thank you very much, Mr. Chairman, and again, it is such a pleasure to serve with you on this committee that I would be happy to sit with you for large amounts of time just to listen to your participation because you have been a leader on so many of these issues.

Mr. HORN. He is going to get me to buy him lunch yet.

Mr. KUCINICH. You know, as I go over this report from the Social Security Administration, there are a number of things that come to mind. First of all, I note that when you talk about some of your key missions, agency goals, rebuild public confidence in Social Security is one of them. That's on page 9, I believe.

I would like to talk to you a moment about that.

First of all, when you send the monthly checks to people or payments that you send, whether it is Social Security or SSI or black lung or whatever, do you send a check, or do you include any message with it at all?

Mr. DYER. We do if there is a COLA adjustment or if we are encouraging direct deposit, we will insert messages. The Department of the Treasury will insert messages for other purposes, too.

Mr. KUCINICH. My background is in communications. That is my educational background that I bring to the Congress. I have a master's in communications from a school in Cleveland known as Case Western Reserve University, and effective communication involves a structured series of messages.

Now utility companies have known for a long time the importance of getting information monthly to their customers when they send a bill. They have those little fold-ins which have information about the service, if people have a concern about their utility bills, other than the fact that we all know that they are too high, and there is a consistent message that is sent out to people. It seems to me that Social Security in particular in its effort to build public confidence and to state its delivery would benefit from a consistent communication with such a structured series of messages which would indicate over and over what this system is about and the service functions which are available.

Now, I'm not talking just once. Since you contact people every month, it gives you a tremendous opportunity to communicate with the public about Social Security. I would go one step further to say that it is particularly important at this time because you have various interests in Wall Street who are just waiting to get their hands on that Trust Fund, and the public, I think, needs to know again about the mission of Social Security, how it was started, why it was started, and who benefits.

I just want to read, if I may, from some passages from the report. This was not in your testimony, but certainly the report is part of the record, and I would assume that as an appendix to this hearing today we could submit this, and I would like to do that.

Mr. HORN. Without objection that will be put in the record.

Mr. KUCINICH. Thank you.

There is a story told in this report which I think is so important. "In 1996 the family income of 16 percent of aged unmarried beneficiaries fell below the poverty line. Without Social Security benefits, 61 percent of those beneficiaries would have income below the poverty line." That is a difference of 45 percent due to receipt of Social Security.

This is a program that is fundamentally important by its definition, Social Security. It is securing the social and economic position of millions of Americans. It talks about aged couples.

> For aged couples, Social Security also lifted many couples out of poverty. In 1996, 3 percent of aged beneficiaries who are members of a married couple had income below the poverty line. Without Social Security benefits, 41 percent of these beneficiaries would have income below the poverty line, a difference of nearly 38 percent.

It's another fact from this report.

> Ninety-five percent of people aged 65 or over in calendar year 1997 were receiving benefits or will when their spouses retire. The largest category of beneficiaries over 65 is retired workers. About 98 percent of children under 18 and spouses with children in their care under 16 can count on benefits if a working parent dies.

Then this report goes on to say, and it is a quote,

> While many of the Nation's aged population have income from other sources, a portion of the beneficiary population relies heavily on Social Security. For 18 percent of beneficiaries, it is the only income. For 30 percent of the population, it contributes almost all of the income, and for 66 percent of beneficiary units, it is the major income source.

I think as we review this financial report, we have to put it in a human context. We are not just talking about numbers here. There are people, millions of people, whose very existence depends on how these numbers are put together, but we are talking about people. Somewhere there is somebody who received their check, and that was important in helping pay the rent and buy food and enabling people to survive. That's what these checks do. People wait for these checks to arrive, and people are very sensitive to Social Security because their whole life sometimes revolves around that check arriving or going into their account.

I would say one thing. Perhaps the difficulty you had with direct deposit and accepting it is the fact that part of the monthly ceremony in many households was the arrival of the check. They want to see it, touch it. They want to look at the name and amount and then deal with it. It is a question of autonomy here. I understand that. I really do understand that, but I will go back to what I said to you, Mr. Dyer, is there anything that would stop you from communicating more frequently with Social Security recipients?

Mr. DYER. Mr. Congressman, we agree with you that we need a concerted communication plan. A year or two ago we set up a separate Deputy Commissioner for Communications, so organizationally we now have a focal point and a real emphasis on that. In terms of what we have been doing this year with the President asking for a national dialog on Social Security and looking at how to reform it in the future, we have been involving our employees in our offices to be out in the community to assist communities and having forums. We have been working with AARP and others. The President has been involved in this.

We are trying to systematically put out the message of what Social Security is about, as you mentioned, and how it provides a major amount of income for the elderly who are retired; how it works; that it is not only a retirement program, but it is also a survivor's insurance program and for disabled people; and make sure that people understand that 3 out of 10 people in the labor market will become disabled. So we want to explain it.

The other tool that we have been using besides working on schools and other places and making ourselves available to speak systematically is the personal earnings and benefit estimate statement, which the Congress asked us to start to issue a few years back and, by the year 2000, we will be sending it out to everybody who is 25 years old and older, and it tells them how much they will get upon retirement based on their earnings history. We will also run calculations if they make assumptions on what additional earnings they will make, what they will get from us upon retirement. And as we send out that information in that pamphlet, we are going to be sending out a lot of messages that you just stated.

Mr. KUCINICH. I think that is so important because those who have a pecuniary interest in trying to take over Social Security are trying to precipitate an intergenerational war, to have the young who are income producers right now abandon Social Security, and the fact of the matter is if you are communicating, if wage earners do have information about the money they have in there and how solid it is and how it will be there for them, there is more assurance and, I think, public confidence in Social Security because people who have had contact with the system know that it works. The level of public confidence which you mention in your report, I think, relates to those events, contact with the system. How can you have contact with the system and not have confidence with it because the check is there. This isn't the story about the check is in the mail, the check arrives.

To go back to this, I would urge you to consider putting a—using that—the monthly occasion, I know that you have direct deposit, and that might change it in some cases, but you do have a chance to communicate with people and to use it more often, and it becomes more important in the next few months and years.

I would also like to point out from your overview of SSA, you mentioned that most elderly Americans were living in poverty in 1935 when the Social Security Act established a program to protect aged Americans from loss of income due to retirement.

Now, we used to hear euphemisms about the poorhouse, but we don't have an aged population now. Sure, we have some elderly poor that we are very concerned about, but that is an issue away from Social Security. This Social Security Act has worked, and that needs to be said in this context of a financial report.

Now, I note in your accountability report under support to other programs you talk about Medicare where the Social Security Administration is the primary public contact point for the Health Care Financing Administration, and that you provide key services to the Medicare program. Could you tell me about that, about the contact between you and Medicare and what the services are that you provide?

Mr. DYER. The services we provide are when someone retires, we at the same time get them their Medicare card. We work through that so they can sign up for Medicare, because they are eligible at 65.

Second, we find that a lot of people come to our offices or call us on our 800 number with questions that relate to Medicare, and we work as a liaison to get them to the intermediaries and carriers who will handle their problems about their bills or whatever is going on.

We also provide information to people coming in on Medicare, and as you know, there are different choices for managed care. We have to be able to provide basic information of where they can go to get additional information or what they need.

Mr. KUCINICH. So you serve as a referral program?

Mr. DYER. We serve a role in Medicare, and we try to answer what questions we can. But a lot of questions—if it has to do with billing, we don't have the capacity. You have to go to the intermediaries and carriers, the Blue Cross/Blue Shields, to do that.

Mr. KUCINICH. Do you get any kind of reimbursement from Medicare for the expenses that you incur as a result of this?

Mr. DYER. Yes. Part of our administrative budget, we are reimbursed by the Medicare Trust Funds. It is about $800 million a year.

Mr. KUCINICH. Now, you refer people to health maintenance organizations, I take it?

Mr. DYER. We will tell people where they can get in contact with resources. We can say, if you are interested, here is a list of what's there. We rely on HCFA to carry the ball beyond that.

Mr. KUCINICH. We are going to get into HCFA next week; is that right, Mr. Chairman?

Mr. HORN. That is right.

Mr. DYER. We give them a list of what are the various HMOs that they can qualify or apply to. We get the information from HCFA and the local community groups.

Mr. KUCINICH. It is a list from HCFA, it is a not a list that you independently verify?

Mr. DYER. No, we rely on HCFA for those kinds of resources. Obviously if our staff in the region see there is something inadequate or wrong with the list, we correct it.

Mr. KUCINICH. I would be interested in getting a copy of the list which HCFA gives you and which you give——

Mr. DYER. I will get you a copy, OK.

Mr. HORN. That will be put in the record at this point.

[NOTE.—The information entitled, "Medicare Managed Care Resource Information Directory 1997," may be found in subcommittee files.]

Mr. KUCINICH. I appreciate that, Mr. Chairman. Thank you.

Tell me about the administration of the black lung program. How many beneficiaries do you have right now?

Mr. DYER. The number is under 125,000. It has been decreasing. We have been primarily handling the folks who were prior to 1974, so our group is slowly passing away, and it has been phasing down. This last year we signed a memorandum of understanding with the Department of Labor, and they are actually going to start doing the cases for us, and we will monitor their performance because it is more closely related to the work that they do. We get reimbursed for our administrative dollars by the black lung program.

Mr. KUCINICH. Do you have your management information systems person here?

Mr. DYER. No. I am the Chief Information Officer.

Mr. KUCINICH. What kind of computers do you use?

Mr. DYER. I'm trying to remember. We update them so frequently. I think they are IBM computers now. I focus more on—right now the box is a box. I'm more focused on what power we get out of the boxes and what is the correct configuration of those boxes. The Inspector General tells me the latest we bought were Hitachis.

Mr. WILLIAMS. They are IBM-compatible, of course, and they did integrate with earlier purchases, but that's the current contract.

Mr. KUCINICH. I'm interested because there are so many different types of computer systems in the government, and some apparently work better than others. If we can take an accounting report which provides a clean accounting with Social Security, and from that we can—it implies that the computer systems that you are using must be pretty good because you don't have a fiscal train wreck going on.

Mr. DYER. We have a centralized system, a mainframe based in Baltimore, and I think the real success in running it is the software.

Mr. KUCINICH. What is the software?

Mr. DYER. It is software we predominantly developed ourselves over the years and improved and enhanced. Now we are looking at more off-the-shelf software for management information because there is a lot more out there. You call them COTS packages. But we find with the kind of volume that we have, we have so many transactions and such high volume for dealing with our beneficiaries, the financial side, too, sometimes we have to do our own work. When we buy off the shelf, we find that we have to do a lot of modifications, so we look and tradeoff as to what is the best investment.

Mr. KUCINICH. Is this software development done by the Social Security Administration, is that FOIA-able? Can people use it to set up their own companies?

Mr. DYER. Most of what we do is so unique to us, I don't think anybody would begin to use it.

Mr. KUCINICH. There are some areas of government, like the National Aeronautics and Space Administration, they have public-private partnerships.

Mr. DYER. At HCFA there have been cases I'm aware of where we have worked on software where, yes, the private vendor has sold it to other agencies.

However, due to our volume and the types of transactions and the history of how we set up our files, we pretty much have stayed with and continue to develop the software that we have.

Mr. KUCINICH. I was just interested to see if anybody has hitched a ride on the expertise.

Mr. DYER. The Office of Child Support Enforcement now is using our data center. They are running their files on our data center as they are bringing up the new files that they are required by law to do. We are working closely with them because we can interact with their data files.

Mr. KUCINICH. I yield back, Mr. Chairman. I thank you for calling this hearing.

Mr. HORN. I thank you very much. I just have a few more questions, and then, if you don't mind, submit the answers to others that staff on both sides will send to you, and they are in the more technological areas of the Inspector General.

Let me get back to a basic program of yours, and the audit report discusses the fact that the Social Security Act has a backlog of continuing disability reviews, and I understand that they are intended to ensure that the individuals are entitled to disability benefits.

Can you tell me how the system works, and does the patient get a doctor, does the government get a doctor, and how do you resolve some of these things?

Mr. DYER. The way that the system works is when one of our beneficiaries, in essence, enters the program, we look to see if we think that they have a high, low, or moderate probability of recovering. We classify the cases. Then systematically we think a 3-year cycle is about right. We look at cases with high probability of success. We conduct CDRs in two ways. One, we send mailers to selected groups of people and ask them to update their information. Second, we actually pull the cases. The person come into our office, and go through a review, and have the State agencies do a medical review. We update the review.

In terms of addressing the backlog, we expect that by fiscal year 2000, we will be current with the title II program, and by fiscal year 2002 we will be current in respect to SSI.

Mr. HORN. What is your definition of backlog?

Mr. DYER. Backlog is based on our internal standards of how frequently we should look at a case, high probability of improvement to lower. I think it averages 3 years when we would review the cases where there is some chance that the person's condition could change.

Mr. HORN. What kind of decision is made that gets them on the benefit?

Mr. DYER. It is done through a system. Our systems kick it out that we have classified——

Mr. HORN. Say I have a disability and I go into any friendly Social Security area office, and the question would be if I am really suffering, and you determine that yes, you deserve the appropriate benefit. How long does it take from the time I walk through that door for the first time before the check arrives?

Mr. DYER. If we allow you through the initial process, it can take about 100 days.

Mr. HORN. That's 3 months plus.

Mr. DYER. Yes.

Mr. HORN. What's the usual experience here of how long it takes?

Mr. DYER. For the vast majority of people it is about 100 days. On average, it is 100 days. If you go into the hearings process where we turn you down at the initial stage, then it can take a year or two.

Mr. HORN. The effect of the backlog, I'm just curious, when you have that jam up, are we talking about several hundred thousand people in the backlog? What are we talking about here?

Mr. DYER. Which backlog are you talking about?

Mr. HORN. The one on the Social Security disability reviews?

Mr. DYER. On the disability reviews, the backlog is 2 to 3 million. Two years ago we did a couple hundred thousand cases last year to 600,000, and this year we will do 1.3 million; next year about 1.6 million. So we plan to catch up by the year 2000. 2002 we will be current.

Mr. HORN. Since you have had an increase in it and you are dealing with big numbers now, in the millions, does this mean that there are truly more disabilities in our Nation, or is there substantial fraud under way?

Mr. DYER. I'm not sure that it means there is fraud. I think sometimes it means that people don't realize that they can go back to work and that they have recovered and tell us that and drop off.

We have found that the net cessations when we do CDRs, it runs 2 to 3 up to 5 percent of the people that we actually reach out and do a CDR do we end up taking off our rolls.

Mr. HORN. Now the effect of the backlog in recognizing individuals that are erroneously receiving benefits, I mean, how many individuals do you really find that are erroneously receiving benefits?

Mr. DYER. As I said, when you net it out, eventually it comes out to about 3 to 5 percent, depending on which type of——

Mr. HORN. In this area 3 to 5 percent?

Mr. DYER. That are ultimately say should not be there.

Mr. HORN. And you are doing what to solve the problem, more people or a different process or what?

Mr. DYER. We have increased the number of people involved in the State agencies. Conducting CDRs is a priority in the agency. We are now also working on the systems so that we can better track and follow through to see what we are finding such as what the recovery rates are, and the number of people coming off.

Mr. HORN. This disability program is essentially administered through the States; is that correct?

Mr. DYER. It is done both through the States and through the agency employees. The beneficiary comes to one of our offices. The medical review is done by the State. The appeals are again done by SSA employees who are administrative law judges.

Mr. HORN. Uh-huh.

Mr. DYER. About 30,000 of our employees' work each year is devoted to the disability process, and at State agencies, there are about 15,000 employees out there doing it.

Mr. HORN. Are there States that do not participate in this program?

Mr. DYER. No, all States participate.

Mr. HORN. All 50 States.

While we have been having this exchange over the last hour, a constituent has asked how does the Social Security Administration account for individuals who continue to collect or accept money on behalf of deceased relatives; in other words, they don't notify them that Aunt Minnie died and the checks keep coming in? How many cases do you have like that?

Mr. DYER. I will have to get you that. I don't have it with me.

Mr. HORN. I can see where mischief could be played with that.

Mr. DYER. We get reports from the funeral homes, and the States give us their vital statistic data, and we also get data from the banks online. For instance, for direct deposit, if the bank hears the person is deceased and goes to close the account, they notify us simultaneously.

Mr. HORN. How about county registrars?

Mr. DYER. We get the State vital statistics, so we eventually catch up.

Mr. HORN. The gentleman from Ohio has a question on that.

Mr. KUCINICH. Thank you, Mr. Chairman.

As a followup, Mr. Dyer, if someone passes away and they have been a recipient of Social Security checks, let's say that their family notifies the bank and said they lost a loved one. They had direct deposit, let's say. Don't send any more checks. The bank tells Social Security. I've heard that in some cases the checks keep coming for a few months. Do you know about things happening like that?

Mr. DYER. I'm sure that we can always find some cases.

Mr. KUCINICH. Despite people telling the banks—is there ever a lag time between the bank notifying the Social Security system? Maybe the Inspector General's Office would know that.

Mr. DYER. Let me also correct the record. This procedure with the banks was done in the last few years. We realized we had to do it, and we worked with them. We are very interested in updating our files if someone has died. Anything that we can find to do that, we track it down.

Mr. HORN. The Inspector General might want to do a random survey. Do the banks even know they have this little task to do, because banks have a high turnover of personnel and a high turnover of mergers. One never knows whether you've got any training program or not, or that person might have been hired by another bank and so forth. You might want to look into that.

Mr. KUCINICH. My concern is if the banks don't notify Social Security quickly enough, and the checks accumulate in the bank, is there a float that develops, and the banks can make interest off that?

Mr. DYER. My staff just informed me that in 98 percent of people passing away, we are basically notified by the families. The area where we are exposed is about 2 percent where there is failure to report to us within a month.

Mr. KUCINICH. Thank you.

Mr. HORN. Let me just conclude this hearing with making a few comments here.

The financial management that we have been studying in various major agencies such as yours, and yours is sort of at the top of the list of people that have done it well, is the foundation for a lot of activities at the Federal Government. We have the Government Results and Performance Act on the books, and we are getting strategic plans in at last, they aren't too good for many agencies, and they will be redoing them, but some are very good.

Obviously the financial management data is absolutely essential in terms of developing appropriate performance goals. Oregon has its benchmark system, which is the only State in the United States that is equal to New Zealand and Australia, which are the only nations in the world that have a sensible government analysis system. As to are the programs working or aren't they working, is the customer satisfied or not? That is the problem Commissioner Rossotti faces as he goes over to give the first executive managerial leadership that agency—the IRS—has ever had. Usually it is tax lawyers and tax accountants, and he is actually running an organization, and he is trying to turn the agency around.

It is going to take several years dedicating 18 hours a day to this thing, and that's why we need to make sure that these systems are working and not have the weak financial management that we have seen in a number of agencies that have been before us. Billions of taxpayer dollars go unaccounted for, and we all pay the price as a result of that. The hearings this week have illustrated certainly the consequences of poor financial management before you all came in here, and we are glad to see one agency that is working. That is partly why we made you independent a few years ago, and we wanted to get you away from the politicians, as much as we could, in HHS among others. So we think what you are doing, is doing it very well.

One of my friends in a previous incarnation was a gentleman by the name of Wilbur Cohan, who as a young man, was one of the three who developed the Social Security Act idea. Wilbur used to carry a list around in his pocket of millionaires who were no longer millionaires who needed Social Security. It was very interesting.

When we were writing up Medicare, we practiced a lot of what Social Security had successfully done as the basis for getting the Medicare system going. Even though there are different rates now and all of that, the idea was that this was a conservative way to fund it because otherwise Congress was just willy nilly authorizing programs, never had any income. They just did it, gee, strangely just before every election.

So we will look at Medicare next week with the Subcommittee on Oversight and Investigations and the Subcommittee on Health and Environment of the House Committee on Commerce chaired by Mr. Bliley. He has been kind enough to ask us to join him in this endeavor, and we will be looking at Medicare and Medicaid next week.

Last year it was reported that there was $23 billion in overpayments by the Health Care Financing Administration some of which were fraudulent. We will also be holding a hearing on Tuesday on the Inspector Generals, and this is the 20th anniversary, as Mr. Williams, a distinguished Inspector General, knows. We want to get deeper in terms of how we get at the waste, fraud, and abuse that a lot of people believe occurs in all levels of government.

And it is sort of fascinating when your constituents look at a poll, and now I'm looking at a legitimate poll, not just a mail-in, although it has been fantastically strange that both my mail-in poll and a legitimate public opinion poll have about exactly the same percentages, where they believe most of the fraud is in the Federal Government, believe it or not; and then they get down to the State government, less fraud there; local government, less fraud there.

What does it tell us? Does it tell us simply because the local government is there, they see the city council in action, they can touch it, they see their city council person more than they see the U.S. Senator or President or their U.S. Representative? And so you have a lot of different factors that go into it, but this is what, as we move toward a results-oriented government where we are looking at particular options that get the job done and have new thinking, and there is no question the cities in America and the counties have been the governments with the new thinking, the new innovation, and we need to apply some of that to the Federal Government, even in an agency that is generally very well run such as the Social Security Administration.

So I thank you for coming, and I want to thank the staff that prepared this hearing, J. Russell George, staff director and chief counsel to the subcommittee; Dianne Guensberg, a detailee from the General Accounting Office; Mr. John Hynes, professional staff member; Matthew Ebert, clerk; Mason Alinger, the staff assistant; David Coher, intern from USC, the University of Southern California; Kami White, an intern; and Faith Weiss, the professional staff member for the minority, and I'm not sure who else is here. Jean Gosa, the clerk for the minority; and Julie Moses, congressional fellow; and then we thank our court reporters, Doreen Dotzler and Katrina Wright, and with that we are in recess until our hearings next week.

[Whereupon, at 12 noon, the subcommittee was adjourned.]

MAKING THE FEDERAL GOVERNMENT ACCOUNTABLE: LEGISLATIVE OPTIONS TO IMPROVE FINANCIAL MANAGEMENT

THURSDAY, JUNE 18, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 311, Cannon House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Kucinich, and Turner.

Staff present: J. Russell George, staff director and chief counsel; Matthew Ebert, clerk; and Faith Weiss, minority counsel.

Mr. HORN. The Subcommittee on Government Management, Information, and Technology will come to order.

We are here today to discuss possible congressional actions to ensure the success of financial management reforms in the Federal Government. This subcommittee takes very seriously the need to resolve longstanding financial management problems that plague the Federal Government. Billions of dollars of taxpayers' money are being lost each year to fraud, waste, abuse, and mismanagement in hundreds of programs in the Federal Government. One of the root causes of this loss is simply poor financial management. The Government's financial systems and practices are obsolete and ineffective and do not provide complete, consistent, reliable, and timely information to the congressional decisionmakers and agency management. It is our belief that losses can be identified and significantly reduced by improved management.

Congress enacted a series of laws designed to ensure that agency management problems were fixed. In fact, the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994 and amended by the Federal Financial Management Improvement Act of 1996, provided the most sweeping reform of Federal financial management in over 40 years. However, agencies have yet to implement these laws fully. Congress needs to provide the incentive do to so.

On March 31, 1998, the General Accounting Office released its audit report on the financial status of the Federal Government required under the act. This report provided for the first time, a concise accounting for the many problems faced by the Federal Government. The first ever Governmentwide financial audit demonstrated that there are serious problems with financial management in a majority of the Federal agencies.

GAO's audit report provided a synopsis of the significant financial systems' weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, that prevent the Federal Government from accurately reporting a large portion of its assets, liabilities, and costs. According to GAO, these problems affect the Federal Government's ability to accurately measure the full cost and financial performance of programs and effectively and efficiently manage its operations.

The subcommittee held a hearing on April 1, 1998, to examine the results of the Governmentwide audit and then held a series of hearings examining the results of the audits of the Internal Revenue Service, the Department of Defense, the Social Security Administration, and, later, the Health Care Financing Administration.

Oversight by this subcommittee and subsequent efforts on the part of Mr. Armey, the majority leader, and Mr. Neumann of Wisconsin, are having an effect. On May 26, 1998, the President issued a memorandum to the heads of executive departments and agencies directing the Office of Management and Budget and the heads of certain agencies to take steps to resolve issues preventing a clean opinion. I want to commend the administration for that action.

Today, we'll consider steps Congress can take to rid the Federal Government of pervasive financial management problems. Not only do those problems preclude an audit opinion, they undermine the confidence of the American people. The Federal Government needs to manage the funds entrusted to it efficiently and effectively. To do otherwise is a violation of the trust taxpayers and citizens place on their Government. These problems are severe, and we can't allow them to persist.

We welcome today's witnesses. Oversight by this subcommittee will be continued this morning.

Before we turn to our first witness, I'd like the ranking member, Mr. Kucinich of Ohio, to have an opening statement.

[The prepared statement of Hon. Stephen Horn follows:]

ONE HUNDRED FIFTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

2157 Rayburn House Office Building
Washington, DC 20515–6143

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"Making the Federal Government Accountable: Legislative Options to Improve Financial Management"

April 16, 1998

OPENING STATEMENT
REPRESENTATIVE STEPHEN HORN (R-CA)

Chairman, Subcommittee on Government Management,
Information, and Technology

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We welcome the witnesses and look forward to their testimony.

Mr. KUCINICH. Thank you very much, Mr. Chairman, and thank you for the work that you've done on this issue.

Out of respect and consideration for our distinguished majority leader and for Congressman Neumann, I would ask to, without objection, put my statement into the record. It's kind of a lengthy statement, but I think it's important to hear from these witnesses. So I'll just, without objection, submit the statement, and then at the Chair's discretion——

Mr. HORN. It will be put in the record following mine as if read and——

Mr. KUCINICH. Thank you.

Mr. HORN [continuing]. Without objection. I thank the gentleman.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Opening Statement of the Honorable Dennis J. Kucinich
Subcommittee on Government Management,
Information, and Technology
Hearing on:
Making the Federal Government Accountable
June 18, 1998

This Subcommittee has held a number of hearings on the topic of financial management. We considered the first government-wide financial audit, and the audits of four agencies that account for 95% of the Federal budget, the Department of Defense, HCFA, IRS, and SSA. Chairman Horn and the Subcommittee has done a great deal to raise public awareness on this issue and to bring pressure to bear on agencies.

Sound financial management by the Federal government is important to all Americans. Since 1990, both the Congress and the Clinton Administration have developed a more proactive approach to improving financial management. The 1994 law mandating first government-wide financial audit was passed by a Democratic Congress with the active support of the Clinton Administration.

We should keep in mind that last year was the <u>first</u> financial audit of the entire Federal government ever conducted. It was only the <u>second</u> year that most of the 24 major agencies conducted an agency-wide audit.

The Clinton Administration has devoted time and resources to improving financial management. In 1993, Vice President Gore recommended annual consolidated financial reports and comprehensive government wide accounting standards as part of his "reinventing government" initiative. The Federal Accounting Standards Advisory Board (called FASAB) -- made up of representatives from the Treasury Department, OMB and the GAO -- completed the basic Federal government accounting standards in record time. The Administration submitted the first government-wide financial audit by the statutory deadline of March 31, 1998. This was truly a massive undertaking.

Moreover, following this audit, President Clinton sent a memorandum to each agency head requiring action plans and reporting by agencies to ensure that the government receives an unqualified opinion on its FY 1999 audit. This is an ambitious goal. But it is representative of the Administration's dedication to the issue. Agencies that do not have "clean audits" and good internal controls must submit action plans to OMB on July 31, 1998, and provide OMB with quarterly reports on their progress. OMB will monitor agency progress towards the goal of a "clean" government-wide audit as well as clean opinions at each CFO agency.

The Administration's efforts are beginning to pay off. Nine of 24 of the major agencies received clean opinions -- meaning that their financial statements fairly present the financial condition in accordance with generally accepted accounting principles. Six of the 24 received "qualified" opinions, which means that their financial statements fairly presented their financial condition in accordance with generally accepted accounting principles, with certain identifiable exceptions. Agency CFOs predict that a clear majority -- or 15 -- of the 24 largest agencies will have clean opinions next year.

Without question, there is a need for intensified financial management by Federal agencies. I support incentives and appropriate consequences for agencies that fail to improve financial management given reasonable expectations. I cannot, however, support penalties imposed "across the board" on agencies without regard to historical and current circumstances and the severity of their financial management problems.

I welcome testimony today on different options for appropriate incentives and consequences to encourage better financial management. However, because the impacts of this type of legislation could dramatically affect each one of the major Federal agencies, it is premature to consider legislation until we hear from the Administration directly.

Congress must not impose consequences that will be counterproductive for agencies or that would deprive them of necessary resources now that they are squarely facing two immense challenges -- assuring that they will be Year 2000 compliant by December 31, 1999, and correcting financial management problems that have resulted from decades of inattention.

I would like to thank the Chairman for having this hearing.

Mr. HORN. We now move to panel one, the distinguished majority leader, Mr. Armey, who has taken a real interest in this problem, and indeed has had a war room, if you will, where the very fine staff he has and others involved, including majority and minority, on various issues look at these statements so that we could look at it from a congressional perspective. I think most of us came to agreement that much more work needs to be done.

So, Mr. Armey, the floor is all yours.

STATEMENT OF HON. RICHARD ARMEY, MAJORITY LEADER, AND A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARMEY. Thank you, Mr. Chairman.

Let me begin by first expressing my appreciation for yourself and this committee for your efforts on maintaining this focus and the discipline of this focus. I believe that without your efforts, we would not have even as much attention to these kinds of details from the administration as we are now seeing.

The fact of the matter is what we do here today in this committee and what you do each and every day is not necessarily the most exciting and sensational work on the Hill, but it is the work that focuses on the imperative need for quality workmanship. While our discussions in here may not be particularly scintillating to people other than CPAs, it is still nevertheless important.

I did want to sort of try to add my clack to sort of make the discussions a little more exciting by pointing out that fundamentally what we're doing here is the same thing that must be done by every person, family, or enterprise in their ordinary business life, search for the equal marginal conditions of allocative efficiency and meet those conditions. You cannot do that without good information and the gathering of information. The analysis of information, the process of making decisions based on good information, is all a rigor and a discipline and one that the world recognizes as imperative, irrespective of how difficult it is.

So while I'm thanking you for continuing this rigorous focus, I also want to thank Mark Neumann for his continued leadership and his continued insistence on this. Mark Neumann, as we all know, can be a very stubborn person. [Laughter.]

Is it acceptable, Mr. Chairman, for me to cast aspersions on my co-panelists? [Laughter.]

Mr. HORN. Actually, it's a compliment, so the Chair rules.

Mr. ARMEY. It certainly will come as no surprise to anybody in the body, but it is important to be stubborn about these things, because these things are exactly the things in our own lives we can more easily than many find ourselves relaxing our standards and failing to achieve with a level of rigor.

When you realize that the Federal Government spends $50,775 every second—every second—it spends more money in 1 second than most Americans earn in a year. When you realize that is, in fact, their hard-earned money and that we do have a genuine oversight responsibility to see to it that we follow the best, most rigorous procedures possible to see to it that that money is spent with discipline, efficiency, and effectiveness in their lives. Then you begin to understand the importance of this task that we have that is undertaken here in this committee.

Not only is it important that we have a rigorous documentation of what we have, where are our assets, where are our liabilities, where are our resources, and how are they being moved back and forth, but we have to have that information to make any evaluation of the performance of Government on behalf of the American people. So the two things, the two oversight responsibilities of accounting, measurement and evaluation, are essential responsibilities of the Congress.

We should keep in mind that it is not heroic when Congress fulfills these responsibilities. People do so in their own everyday lives. Anybody with their own business understands the benefits of cost accounting, and managerial accounting, and the importance of good data in order to fulfill the requirements of those accountings to sound decisionmaking. They also understand the consequences, the very real consequences, that return to themselves and their enterprise, if they fail to achieve this rigor.

If a person were running his own small landscape business and he misplaced their mower or their pickup truck, I can guarantee you that their first order of business would be to find it, so that they could be back to work the next day. To do so, they could just simply not afford to leave pieces and parts laying around. Anybody in a hardware store will tell you without a trackable inventory control system they can't stay in business. Every American family must keep a budget and keep track of their household items and watch where they spend money. I can tell you it is—and we've seen this before in my own testimony—it is sometimes the responsibility of the wife to hold the husband accountable to find that missing bass boat, which I'm sorry to report is still missing. [Laughter.]

I remember when Billy Jo Armey lost his bike, and his mother didn't let him come home until he found it because that was one of the family's assets, hard-earned, important in the family's life.

So again, I think we need to emphasis this fact. We are not asking the Government of the United States and its agencies to be heroic in keeping track of who they are, what resources they have, where do they spend money, where are things warehoused, and accounting for the effectiveness in the use of this.

We have so many important considerations that we can make more effectively if we can get beyond sloppy work. And, Mr. Chairman, I use that word "advisory," and I do not want it to be seen as an indictment of people. We are all capable of sloppy work. I, myself, with that darn bass boat that I have demonstrated.

But we are also responsible to maintain some standards, and the sloppy work with other people's money in matters of the kind of consequence that we have before us in public policy is something that we have a responsibility to eliminate to the absolute best of our ability. Only if we eliminate that and have this accurate information that good accounting and auditing procedures can give us, will we be able to judge such things as which of the 90-odd childhood programs work, and why do they work? And if they don't work, which should be eliminated?

Do we have performance measures and data that show whether or not bilingual education programs really do help or hurt particiidentified. People must be held accountable. People must see the consequences in their own personal lives and people must, therefore, then be incentivized to do better.

I believe this committee has done good work in these areas. I believe this committee has made this a lively issue in public policy discourse. This committee is continuing to make this a known, accepted, and practiced commitment of this legislative body to see to it that we cover all the fine details and accept the responsibility for all the rigor and all the discipline so that we give proper oversight to the use of the American people's tax dollars in each and every agency to the maximum service to these same American people in their ordinary business lives.

I'll conclude by saying, Mr. Chairman, you have my support and my encouragement. I would hope that the committee in this effort would see my office as a resource. Please do call on me. This work is as important as any work that is done on this "hill," and frankly, in my estimation, more important than much of the work.

So thank you for letting me be a part of it today.

[The prepared statement of Hon. Richard Armey follows:]

pants? Do job training programs have performance goals and targets that measure how many participants actually get and retain jobs, or are we content to measure that in terms of how many people are trained? And what is the appropriate, and are we accurate in either case?

We've already uncovered some frightening things. It took the Pentagon—and watch this process. It took the Pentagon 6 months only after adverse publicity and exposure to find the lost missile launcher in Farmington, NM. If I can add parenthetically, Mr. Chairman, I was in Farmington, NM, during that time. If I had only known, I would have helped them to look for it.

We now find that there are 220 extra tanks in 1 Army unit in contrast to the records that the Army command has. Now, I mean, it's no little thing to lose 220 tanks; they could become useful on occasion if we just knew where they were and how we might deploy them.

Mr. HORN. It shows that unit has a good Master Sergeant.

Mr. ARMEY. Absolutely, yes.

Six inactive Navy service crafts, out of 79 total. I know it's a big ocean out there, but we ought to be able to find where these six inactive service craft are. While we don't want to pick on the Pentagon, we do want to understand that the Pentagon must achieve the same rigor as anyone else.

Now if we can be more effective in auditing, measuring, understanding, and then evaluating, then we can do what it is our essential responsibility to do, to see to it that the taxpayers get the value for their dollars.

And as we consider the legislation that's before your committee today, and other alternatives to provide incentives to this, Mr. Chairman, while we must have a resolve about this—and we must be insistent about it—we should also make it very clear that we are not intending here to be punitive. What we're intending to do is to endow Government service in every agency and every operation with the Government with the same rigorous, the same requirements, for understanding who they are, and what they're doing, and what it is they do it with, and evaluating their results as everybody in America experiences in the ordinary business of life.

So as you look into this question of how we can better incentivize people to achieve these levels of rigor and performance, let me suggest the three objectives that you might adopt to govern your proceedings.

The first objective would be to improve financial management as quickly and as effectively as possible, to ensure clean audits are the rule and not the exception. The second exception is to assure that this Government is not hypocritical, that this Government complies with the same standards that the Government, itself, applies to families, and to State and local governments, or to other contracts. The third thing is to improve accountability, to find out who are the individuals responsible for the failures and incentivize them to greater levels of performance.

You should consider all the options available to you. But you have to get beyond the notion of institutional failure and understand things don't just happen. People do things. People must be

Testimony by Dick Armey
House Majority Leader
Before the House Government Reform and Oversight
Subcommittee on Government Management, Information and Technology
June 18, 1998

The Federal government spends $50,775 every second. Washington spends more money in one second than most Americans earn in a year.

Everyday we in the Congress make decisions on how to shape federal programs and apply limited federal resources in ways that make the wisest use of taxpayer dollars and achieve the greatest good for our citizens. Nothing is more basic to our responsibilities as Members of Congress.

For that reason, it was most disappointing to find out how poorly the government accounts for its spending and resources when we learned in April about the findings of the first government-wide financial audit ever conducted.

Equally frustrating has been our efforts to find performance information -- with our efforts to implement the Results Act – to tell us whether federal programs are working or not.

Sound financial management is intricately related to an agency's ability to meet its performance goals.

Every business in America, even the smallest mom and pop store, knows intuitively, the benefit of cost accounting and the importance of good information about their property, inventory and equipment. To have a successful business, owners must have a firm grasp of their assets, their liabilities, their budget, and their inventory. For instance:

- If a person running a landscape business misplaced their mower or pick-up truck, they'd be focused on finding it fast to continue their work.
- Any owner of a hardware store must have a trackable inventory system, or they won't be an owner for long.
- Every American family must keep a budget, keep track of household items, and watch where we spend our money.

Yet, we have a government that doesn't know what they have, can't find many important pieces of equipment, and can't account for how it is spending our money. More importantly, we have a government with no consequences for such a state of affairs.

In the private sector, if there is not reliable and complete information, there are consequences -- consequences for employees, for owners, for family members.

Today we are here to start a discussion about enhancing the consequences for sloppy work on the part of our federal agencies.

Once we get more solid accounting and financial information, we can improve our decision-making, and the ability to monitor agency goals that affect the lives of citizens. We need to get to questions such as:

- Which of the 90-odd early childhood programs work and why?

- Do we have performance measures and data to show whether bilingual education programs help or hurt participants?

- Do job training programs have performance goals and targets that measure how many participants actually get and retain jobs, or do we measure success just in terms of how many are trained?

Although I have no desire to unfairly single out the Pentagon, at a time of enhanced attention to the needs of our national security, it troubles me that:

- It took the Pentagon six months, following adverse publicity and exposure, to find a lost missile launcher in Farmington, New Mexico.
- There were 220 extra tanks in one Army unit, in contrast to the Army's central records.
- There were six inactive Navy service craft, out of 79 total, that could not be located.

Each agency had its own problems, as you know Mr. Chairman.

This government should be a service in the lives of the American people. As stewards of this government, we in the Congress must do everything we possibly can to see that Washington spends other people's money as carefully as we spend our own. Taxpayers want the truth – they want an honest assessment of how Washington is spending their hard-earned dollars.

If we can reduce the cost of government, create a smaller, smarter, common sense government, then I am confident that we can further reduce taxes and deliver better, less costly services. This subcommittee has been on the front lines of looking for creative ways to do just that.

Today, we are here to discuss what new laws we can pass that get agencies to change, to improve, to get a clean audit and be focused like a laser beam on being fiscally responsible for taxpayer dollars.

We should attempt to develop consensus legislation that can be enacted this year.

I commend you, Mr. Chairman, for this effort. You and your colleagues are offering creative and effective ideas to change the way Washington works and to help us get a smaller, smarter government. One of the lessons we can observe about the lost, and then found, missile launcher is: when the press or when Congress focuses attention on a problem, solutions are found. Exposure, attention and sometimes, embarrassment, are change agents.

I would hope that any new legislation would meet the following objectives:

(1) Improve financial management as quickly and as effectively as possible, ensuring clean audits are the rule, rather than the exception.

(2) Not be hypocritical – we should apply the same standards to government that government applies to families, to states or local governments, or to contractors.

(3) Improve accountability of those most responsible for failures.

You should consider all options for strengthening our financial management laws.

Mr. Neumann's legislation has tremendous merit and begins a useful discussion of what we can do to get better results for the taxpayers.

I encourage each of you on this subcommittee to be as creative, as firm and as clear as you possibly can to ensure that taxpayer dollars are as precious to you as your own money. Let's not waste any time in addressing this matter.

Good luck and know that we are awaiting your legislative changes in hopes that you find the way to ensure we will have better results in the next government wide audit. The taxpayers deserve better.

Mr. HORN. Well, we thank you for your generous comments, and we would welcome thoughts as we go along.

The aim of the subcommittee over the last year or so is to move toward real measurement indicators in each executive branch program so that both the executives in charge of that program, the average citizen, and the Members of the Congress can see what progress is being made to serve the clientele, namely the American taxpayer. So we are very interested in doing that, and we welcome your kind words and guidance.

Mr. Neumann, besides your stubbornness, you are also persistent. [Laughter.]

STATEMENT OF HON. MARK NEUMANN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. NEUMANN. I would just point out that that stubbornness——

Mr. HORN. We need more like you.

Mr. NEUMANN [continuing]. And persistence comes from the private sector, where I had to go through audits every year. And I guarantee you, if I went looking for 79 lots that my building company owned that we planned to build homes on in the following year and couldn't find 21 of them, which is the case with the Navy when they went looking for 79 ships and couldn't find 21 of them. I guarantee you, there would have been some immediate changes in my company.

But I want to start by commending the chairman here, and commending the work of this committee and the efforts that you've been putting in to bring this change about and this improvement about that's certainly very necessary. I will not pick on my good friend, Mr. Armey. Instead, I will simply commend him for his efforts in this area, too. Without your support and without your efforts, this would not have moved forward.

I'd also remind the committee that last week we passed a resolution—I believe it was unanimous on the House floor—that there should be consequences for agencies that do not meet the standards. I, again, go back to the private sector where I come from. The first time we had to pass an audit, the accountants drove me crazy. And you said this is—I think you used the word "mundane" or something like that—for anybody except accountants. I'll tell you, being on the other side of the desk where the accountants made me adhere to their standards and account for every nickel in our industry, it was not mundane. We wanted to know where the money was coming from, and we wanted to know where the money was going to. And the Government, the IRS, wanted to know how much was left in the profit column. And the IRS would not have allowed us to get away with not knowing where the money was coming from or where the money was going to. And that's why we had to have audits every year.

I will never forget the first time, while Larry Eberheart, who's an accountant in Janesville, WI, came into my office and said we were off by approximately $100. Now at this point, the company size was about $8 million in gross sales. And I said, "We're off by 100 bucks, get out of here. That's close." He said, "No, you don't understand. If you're off by $100, that means there's something wrong some place in this accounting process, and we've got to find the $100."

You know, he was right, because if you're off by $100, you might be high in one category by $10,000 and have lost $10,100 somewhere else, and then that, in fact, is $100. You can't let it go. So in the private sector, they demand accuracy in financial accounting, and anything less would be absolutely unacceptable.

When we go through some of these things in this report that the GAO did for my office, and if we have not submitted this to your committee, this was prepared for our office. I'd like to just read a couple excerpts out of this thing.

Regarding Medicare, $23 billion, approximately 14 percent of the total payments for reasons ranging from inadvertent mistakes to outright fraud. That's a 1-year problem in Medicare, $23 billion. Now just think about this for a minute. We talk about everything in Washington in 5-year terms; what we're talking about here is $115 billion over 5 years. And then think about the tax cut debate or think about the Social Security debate or any of the other debates and how much money is being talked about just in this one area.

And I'm not going to read through all of these, but there's a couple of others that I'd like to quote word for word. This is the one that bothers me the most of all, and I think in terms of threat to our society and threat to our people here in our country, our constituents, this is the one that we ought to be the most worried about. It's the Air Force logistic system, and I'm quoting now directly from the GAO audit, "The three data bases included in the Air Force's central logistic system contained discrepancies in the amount of equipment on the number of assets on hand, including ground-launched and air-launched cruise missiles aircraft and helicopters."

What they're saying here is that the records in the Pentagon that show how many missiles we're supposed to have versus the actual missiles out in the field don't match up. So we are literally missing ground-launched and air-launched cruise missiles.

This is like somebody coming into my office—one of our employees when I was running the building company and going, "Hey, Mark, you know this list of lots that you've got available to build? Well, we can find most of them, but we're missing a few out there. Is that all right?" It's not all right. When you're talking about missiles here, we're talking about a threat to the country as a whole, and it's not all right to have even one discrepancy in terms of where the cruise missiles are.

In terms of going back to private-sector experience, if somebody were to come in and say to me, "Mark, by the way we lost $100,000 out of your accounts this year. It's an $8 million gross sales business, and we lost $100,000; we're doing pretty good." That's the Forest Service. The Forest Service has a budget of $3.4 billion, and they lost $215 million. How can you lose $215 million? Let me read again, that direct quote from the GAO audit. "The Forest Service could not determine for what purposes it spent $215 million of its $3.4 billion in operating and program funds."

I introduced legislation, and I very much appreciate the opportunity to be here this morning. I genuinely believe in the private sector, that our company would not have been profitable, as it was not profitable in the first year, it would not have been turned around had we not shown a stubborn streak or a determined effort to make sure that we were able to account for our money.

I think in the U.S. Government, unless we show this determination and unless we put some teeth into this, it's going to take a long time to clean this up. I really believe that if you do as we did in the private sector, and attach consequences to failure to perform in your prescribed job, that we'd clean it up in a big hurry.

Again, I'll never forget in the private sector, we had a person working for us who was as loyal as the day long. He would absolutely work his tail off. He'd work 16 hours a day if necessary to get his job done because he cared about his work. But he didn't have the qualifications to do the job that he was doing, and as a result, no matter how hard he worked, he was not able to succeed.

I guess when I introduced legislation looking at this process, it's not like a slam that somebody in Government is intentionally going out and doing something wrong. But if we have people in these positions that are not able to accomplish their job and have demonstrated that they can't accomplish the job that they're given to do—I find the money in these various agencies and account for that money—well, then I think we need to replace those individuals as we did in the private sector with this individual. Do you know what? When he left our employment, and we helped him find a different job that he was more qualified to do, when he left our employment, he came back a couple months later and said, "You know, Mark, it's the best thing that ever happened to me in my life." So when the person was in a position that he could not perform his duty, we helped him find a different position that he could perform, and it made his life much better.

By the same token, the people that are responsible for passing these audits, if they can't get the job done in a 12-month period of time, I think they should be allowed to find some other occupation, perhaps outside Government. The legislation that we've introduced—and I believe it's been referred to your committee—suggests that we look at these agencies that are not able to financially account for the dollars-in and dollars-out of their agency, we identify the people responsible for the accounting process in each agency—and I think this is real important. It goes from this generic, "somebody out there done it," to a specific this person and this group of people have responsibility within the agency to track this money. Give them 12 months to clean it up. Give them 12 months to get an operational accounting system in. I want to tell you in the private sector, we would not have given them 12 months to find the missing 21 lots out of 79. We would have given them 2 days, and if they hadn't found them at the end of 2 days, the problems would have materialized very quickly in their lifestyle.

So I'm suggesting here, because of the size of this, we give these folks 12 months to clean up the books. But if at the end of 12 months they're not capable of performing their job, I think we need to have some consequences. I think we need to replace those people.

The legislation that we've introduced specifically calls for the identification, up front, of the people responsible to clean up the books. At the end of 12 months if they can't pass a financial audit, those folks are let go from Government service and, that means they go somewhere else in a job they're more qualified to do within the Government that's fine. But at any rate, we get them out of that role because it's too important to allow them to stay there if they can't get it cleaned up.

The legislation we introduced also suggests at that point that if the agency is not able to account for their funds, at that point we withhold up to 5 percent of their budget in reserve. Again, the intent here is to put some consequences in there to actually get this cleaned up.

I will make a suggestion and a prediction. If we were to enact this legislation and actually put real teeth in this thing, 12 months from today you would not have a agency out there that could not financially account for the money that's going through the hands of that agency. We talk about Government budgeting reform and tracking reform, and we talk about all the rest of these things, but if, as Mr. Armey said, if we were to have personal responsibility in the lives of the people responsible for getting the job done, I believe the system would be cleaned up.

So, I believe the bill has been referred to your committee. I'd certainly entertain any questions on it. We look forward to you taking a good, hard look at it. Certainly it's one person's idea from the private sector of what might be done, and suggestions or improvements that might be made here in the committee would certainly be something I would appreciate and respect.

So with that, I just again commend this committee for the work you're doing. I think it's very, very important, and it certainly should not be a mundane issue here. It's a lot of the taxpayers' money we're talking about it.

I thank you again for the privilege of testifying.

Mr. Chairman, I'd also ask—I do have prepared testimony that I'd submit for the record, also.

[The prepared statement of Hon. Mark Neumann follows:]

Congress of the United States
Washington, DC 20515

Testimony by Congressman Mark W. Neumann
at the Subcommittee on Government Management, Information and Technology
on June 18, 1998

Good morning Chairman Horn, Mr. Kucinich, and other members of the Committee. I appreciate you requesting my testimony at this hearing on legislative options to enforce financial audits of Federal agencies. Your work in this Committee has led the way to make sure the Federal Government accounts for all the tax dollars we entrust in its care.

The American public, and quite frankly many of our colleagues, may not realize that you have held dozens of hearings on financial management during the past year-and-a-half. I commend you for your tireless efforts. However, despite current laws, your best efforts in this Committee, and some progress made by a few Federal agencies, the Federal Government continues to mismanage billions of taxpayer dollars. More must be done.

As you know, a financial audit reviews the agency's financial statements. As part of the audit, the auditors go through a small sample of the assets listed to confirm the records are accurate. Here are just a few examples of the waste, fraud, and abuse uncovered by this year's financial audits:

- The Department of Treasury could not reconcile $100 billion in transactions between Federal agencies.
- The Army misplaced an Avenger missile launcher valued at about $1 million that could not be found until several months after the audit.
- The Navy misplaced more than 21 vessels, including a tug boat that still cannot be found. It also lost 10 uninstalled engines such as a Harrier jet engine valued at about $4 million.
- The Air Force listed a C-130 air plane as an available asset even though it was destroyed years earlier in a corrosive test.
- The Department of Energy lost a computer valued at $141,000.

- The Federal Aviation Administration listed several demolished buildings as available assets. It also failed to record a new day care center.
- The Medicare program made approximately $20.3 billion in over-payments to health care providers ranging from inadvertent mistakes to outright fraud and abuse.
- The Department of Housing and Urban Development made about $900 million in over-payments for rental subsidies.
- The Forest Service could not determine for what purposes it spent $215 million of its $3.4 billion in operating and program funds.
- The Federal Government does not know how much its credit programs cost.

In short, we cannot trust the Federal Government with our constituents' hard-earned dollars. While some Federal agencies have made progress, they still cannot meet standards we expect of businesses and taxpayers. Is it too much to ask that agencies simply know how they spend tax dollars?

We should keep in mind how long Congress has been making this simple request and how long Congress has been ignored. Congress first began requiring financial audits in the late 1980's and early 1990's. In 1990, under a Democratic Congress and Republican Administration, Congress enacted the Chief Financial Officers Act. This law required financial audits for certain agencies such as the branches of the Armed Services in the Department of Defense. In 1994, Congress enacted the Government Management Reform Act that required audits for 24 major Federal Agencies that culminated in a governmentwide audit for Fiscal Year 1997.

In 1996, Congress enacted additional legislation authored by former Senator Hank Brown of Colorado to ensure agencies comply with applicable financial laws and regulations. In its original form, Senator Brown's bill also contained provisions that penalized agencies that failed their financial audits. His bill fired the responsible individuals and reduced funding by one percent for every year an agency failed its audit. The provisions were removed prior to the bill's enactment.

Our reluctance in 1996 to include a mechanism that would enforce the audits has come back to haunt us. The majority of agencies continue to fail their audits. In fact, four agencies have not even submitted audited financial statements this year and the deadline was nearly three months ago. Federal agencies have ignored Congress and have not made financial management a priority.

Last week, with the Committee's help, Congress overwhelming approved my House resolution calling for consequences for Federal agencies that fail their financial audits. In response, I introduced legislation this week that specifies what those consequences should be. I call it the "Tax Dollar Accountability Act."

For those agencies that fail their annual financial audits or do not even complete the audits, my bill would fire the responsible individuals if the agency's mismanagement continued for 12 more months. After the same 12-month period, the bill would also set aside five percent of the agency's funding in a reserve account. It is important to note, that unlike previous proposals, my bill does not cut funding. The agency would be able to access the account as soon as it passed the audit.

The bill defines audit failure as an agency that does not receive an unqualified opinion on its financial statements. If an agency receives a qualified opinion, only the 5 percent fencing provision would apply and no one would be fired. A qualified opinion means that the agency's books are essentially clean and organized with only a few specific exceptions.

For Fiscal Year 1997, only nine out of 24 Federal agencies received an unqualified opinion. Five agencies received a qualified opinion. Six agencies received adverse or disclaimer opinions. As I mentioned before, auditors have not even submitted opinions for four agencies. Those four agencies--the Agriculture Department, the Education Department, the State Department, and the Federal Emergency Management Agency--have not compiled their financial statements and other appropriate records for a fiscal year that expired nearly nine months ago.

As you contemplate legislation to enforce financial audits, you may want to consider additional factors such as effective internal controls and compliance with applicable financial laws and regulations. Whatever direction the Committee takes, I urge you to maintain a very low tolerance for unaccounted taxpayer dollars. Any amount of waste, fraud, and abuse is too much.

Again, Mr. Chairman, thank you for this opportunity to testify about my legislation.

105TH CONGRESS
2D SESSION

H. R. ____

IN THE HOUSE OF REPRESENTATIVES

Mr. NEUMANN (for himself and [see attached list of cosponsors]) introduced the following bill; which was referred to the Committee on ______________________

A BILL

To hold Federal agencies accountable for the tax dollars spent by such agencies in accordance with the provisions in the Government Management Reform Act of 1994, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Tax Dollars Accountability Act".

SEC. 2. RESERVATION OF APPROPRIATED FUNDS.

Section 3515 of title 31, United States Code, is amended—

(1) by striking subsections (e) through (h); and

(2) by adding at the end the following new subsection:

"(e)(1) Beginning in fiscal year 1999, the Director of the Office of Management and Budget shall reserve from obligation and expenditure 5 percent of the discretionary appropriations for a fiscal year for an agency (or component of an agency, as applicable) that does not receive an unqualified opinion on the financial statements of the agency (or component of the agency) for the previous fiscal year as part of an audit conducted in accordance with section 3521.

"(2) The Director shall make available to an agency or component of an agency the expired and unexpired amounts reserved pursuant to paragraph (1) upon the receipt of an unqualified opinion on the financial statements of the agency or component as part of an audit conducted in accordance with section 3521.

"(3) Paragraph (1) shall not apply with respect to funds appropriated for Offices of Inspector General, Offices of Chief Financial Officers, or any other functions directly responsible for financial management.

"(4) For purposes of this subsection, the term 'discretionary appropriations' has the meaning given that term in section 250 of the Balanced Budget and Emergency Deficit Control Act of 1985.".

SEC. 3. ACCOUNTABILITY OF AGENCY OFFICERS AND EMPLOYEES.

Section 3515 of title 31, United States Code, is further amended by adding at the end the following new subsection:

"(f)(1) For each audit required by section 3521 that does not result in an unqualified or qualified opinion on the financial statements of the agency (or component of the agency), the Director of the Office of Management and Budget and the head of the agency shall jointly submit, not later than April 1, a statement to the Committees on Appropriations of the House of Representatives and the Senate, the Committee on Government Reform and Oversight of the House of Representatives, and the Committee on Governmental Affairs of the Senate a statement that identifies the officers and employees of the agency responsible for—

"(A) the financial management of the agency; and

"(B) the preparation and production of the financial statements of the agency.

"(2) The President (in the case of an officer appointed by the President) or the head of the agency (in the case of any other officer or employee) shall remove from office or employment each officer or employee of an agency identified for two consecutive years in a statement required by paragraph (1).".

SEC. 4. SUBMISSION OF AGENCY FINANCIAL STATEMENTS.

Section 3515 of title 31, United States Code, is further amended is subsection (a)—

(1) by striking "1997" and inserting "1999"; and

(2) by inserting "the Congress and" after "and submit to".

Mr. HORN. Yes, automatically we put all the statements in.

What would you say is the most critical part of your bill, the Tax Dollars Accountability Act, the holding of personal responsibility?

Mr. NEUMANN. The identifying the people responsible up front.

Mr. HORN. Right.

Mr. NEUMANN. So that when a year goes by, when 12 months go by, we know who to look for that has personal responsibility. And I think that's the key, personal responsibility, somebody identified with the responsibility to do the job.

Mr. HORN. Any other thing that you think is the second most important?

Mr. NEUMANN. Well, the withholding of funds from the agency is the way you're going to get the agency members to cooperate with the people responsible to complete the audit, because if you've got accountants in an office and the people in the office don't cooperate with the accountants, they can't do it. So if you've got auditors in there, people tracking the money, and over here you got a group of people fighting to prevent them from being successful, you won't be successful doing the audit.

So there has to be consequences, in my opinion, on both sides, both the people personally responsible for doing the job, and also over here in the agency if the job is not completed. That makes it a team effort as opposed to an accountant versus the rest of the people in the agency.

Mr. HORN. I think you're absolutely correct. You've got to get the Secretary's attention, the top executive's attention to know we're serious, and often that means cutting the agency budget. Do you provide for sort of an automatic cut in a percentage or withholding money?

Mr. NEUMANN. It would be 5 percent, and it would be withheld only on the outlay side only until they can pass the audit. So it's a 5 percent withholding and only until they can pass the audit. Again, I don't think that's an unreasonable amount, but if the committee thinks something else is a better number, we're certainly receptive to the will of the committee.

Mr. HORN. Well, we thank you.

Does the majority leader have any other suggestions to make on this subject?

Mr. ARMEY. Well, Mr. Chairman, I believe very much in the committee system, and I think the committee system works best when it takes a bill under consideration, recognizes that as a marked point of consideration and departure. There are many, many dedicated people on this committee, and we would just naturally expect there would be other things that might be recommended, and the committee would consider that.

I must say, though, if I may, I wholeheartedly endorse the legislation offered by Congressman Neumann. I think it's got the two essential things. It basically says you have the individual or individuals that are personally and specifically responsible to be held accountable, and you then have a broader incentive for the whole team to make the whole operation work. I think it has the two essential ingredients.

I would guess the committee might find ways that they might add to or improve the legislation, and I have so much confidence in the effectiveness of hardworking committees. I would be excited to leave here today realizing the committee is taking this as a point of beginning and will produce some product that I could put on the floor.

Mr. HORN. Well, you can be sure that we will be acting on this legislation very soon.

Well, we thank you both for coming. We know you're both very busy.

Mr. KUCINICH. Mr. Chairman.

Mr. HORN. The gentleman from Ohio.

Mr. KUCINICH. Thank you very much. Wouldn't want to miss out a chance to participate in this.

I want to thank both of you for testifying, and as you know, I actually—and the chairman remembers—I actually worked to round up the votes so we had a unanimous vote last week because I felt that the points that you're making are very important. And I support the spirit in which this effort is proceeding because we have to make Government more accountable. There's no question about that.

I think the efforts of the administration need to be credited with going toward that direction because, as you know, we had the first ever audit of the entire Federal Government. We need to hold the administration to a high standard. But they apparently have taken efforts to try to get as many unqualified opinions as they could. We have four departments covered by that, at least—let's see, actually more than that—nine unqualified opinions. Staff has a chart there, I believe, you could put on display. We have another five with qualified opinions, and then we get into that area of disclaimers which I know the Members who are testifying here, are—we share concern about. Because, Congressman Neumann, you and I were both active in pointing out some of the deficiencies in the Defense Department, and then finally where they are no audits submitted, that's of great concern.

The concern that I would have is that in the bipartisan support that we've had for holding the Government to a higher standard just at a time when we're bringing in the first governmentwide audit, it may be—and I just used the word, "may be"—premature to start to talk about firing people. I remember when we had the Department of Defense in. Mr. Armey, since there's so many Defense contractors, I know in your fine State, this is an interesting point. The Department of Defense actually testified that this condition with their books has existed for about 200 years.

Mr. HORN. Well, since it became a Department of Defense, for sure. The first Secretary did not make 1 accounting system and let 100 or 200 accounting systems emerge, so that's why they can't reconcile the books sometimes.

Mr. KUCINICH. Thank you, Mr. Chairman.

And I wouldn't want to have to see some personnel necessary to our national defense, cashiered because a system really is deficient. However, we're going to hold that Defense Department to a higher standard to make sure that they start to get their books in order.

I want to make sure that when there's accountability, the accountability goes to the generals, not to the privates, not to the corporals, not to those humble people who are toiling away trying to make systems work. Because when we talk about removal from office or employment, I want to make sure that we let Federal employees know that we encourage them to do their job, but usually they are just following orders. If there is going to be accountability, we want the accountability to be at the top, and not simply to find somebody along the line and say, "Well, you're out of here." And what it amounts to is someone scapegoated.

But I think the intent of this is something that ought to receive a full hearing. I am concerned, though, how the implementation might work given the fact that we're just beginning the first ever audit. See, let's say if we were in a period where we had a consistent series of audits over a period of time and then someone would fail, in effect, I think people determine their own fate, and they'd be forced to leave. I'm just concerned about putting the onus on so firmly at this moment on the very same employees that we need to solve the problem. If they don't do their job, they ought not to be working for the Federal Government. I agree with you on that.

Then, the other thing I'd like you to consider, Mr. Neumann, is as you bring this legislation to committee, maybe we should find a way to have it apply to Government contractors as well, who have given us so many problems in terms of accountability. We had this hearing on HUD a week ago where HUD contractors are posing a nightmare. There's hundreds of millions of dollars that are not adequately accounted for through that contracting system. That's another area where we might be able to expand the possibility of your legislation.

So, I appreciate your work on this issue. It's been terrific, and I'll work with you. I just want to make sure that we don't get into some areas where we're taking such a punitive approach, it's counterproductive. I thank the majority leader and Mr. Neumann for their participation because I think this is something we can work together on. I ask the administration to work with us on this because you're setting a higher standard; we'll work with you in raising the bar.

Thank you.

Mr. HORN. I thank the gentleman.

The gentleman from Texas, Mr. Turner, do you have any comment? We thank you for being here.

Hearing no more questions on either side, we thank you both for taking time out of your busy day. Thank you very much.

Next panel will come forward, and that's Mr. Dodaro, accompanied by Mr. Calder and Mr. Steinhoff, General Accounting Office.

You know the routine, gentlemen. We swear in all witnesses except Members of the House.

[Witnesses sworn.]

Mr. HORN. Thank you. The clerk will note that all three have affirmed.

And we begin with Mr. Dodaro, Assistant Comptroller General of the United States, U.S. General Accounting Office. Welcome, again, for your probably 25th appearance before this subcommittee.

STATEMENT OF GENE DODARO, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY PHILIP CALDER, CHIEF ACCOUNTANT, AND JEFF STEINHOFF, DIRECTOR

Mr. DODARO. It's always a pleasure, Mr. Chairman, to be here. Good morning to you, Congressman Kucinich, Mr. Turner.

We appreciate the opportunity to be here today to discuss options for fostering effective implementation of good financial management practices throughout the Government. When I was here 2 months ago before this committee, I talked about the progress that's being made but I underscored the fact that there was a considerable amount of effort and perseverance required in order to bring about the type of legislative reforms that were envisioned by the Chief Financial Officers Act and other financial management legislation passed by the Congress.

As mentioned this morning, our report on the consolidated audit of the Federal Government's financial statements outlined the most serious challenges facing the Federal Government. We've been pleased with the reaction to that report, both by the executive branch and by the Congress.

As you mentioned in your opening statement, the President last month issued a directive to the heads of departments and agencies about addressing the deficiencies identified in our audit and setting forth a process in order to help achieve the administration's goal of obtaining an unqualified opinion on the consolidated financial statements of the Government for fiscal year 1999. Now that process requires OMB to designate which agencies for them to submit a plan to OMB to address these weaknesses. The first plans are due the end of July this year. After that, agencies are required to submit quarterly reports to OMB on their progress in implementing that plan.

OMB is also required under the directive to provide periodic status reports to the Vice President on progress in meeting the goal of obtaining an unqualified opinion for fiscal year 1999.

Now this is an important step, but I would point out two important features that must take place in order for this to be effective.

First, the plans have to be of good quality. They have to precisely define the financial management problems and to set forth realistic detailed strategies. They must fix accountability, and the discussion this morning about accountability is crucial. And they have to set timeframes. So the plans have to be good.

The second point I would make is that the missing ingredient that we've always noted where things do not achieve full expectations is implementation. These plans need to be implemented effectively. The progress reports are critical, and GAO and the auditors should be used as a process of independently judging the progress that agencies are making in implementing these plans.

But implementation is key, especially the involvement of the top officials. I was glad to see the President sent the memo and a directive to the heads of departments and agencies and not just to the chief financial officers. That sends a strong signal that this is a problem that needs to be worked from the top down. But that process has to be followed through. It's easy to issue directives, but to actually translate them into concrete improvements will take a considerable amount of effort.

We're also pleased with the actions taken by the Congress. The series of hearings that this subcommittee has held have been very important in sending a message to the Federal departments and agencies that the Congress has a strong interest in seeing these reforms carried out appropriately. Other congressional committees are also increasingly using the results of financial audits and asking GAO for interpretations of the results and analysis of the issues that are being raised by the audits. Also the resolution passed by the Congress recently underscores the congressional resolve to bring about changes in this area. All those efforts are very good and are providing a good impetus and example for the agencies.

Also, the reform that the Congress set in place in 1996 in the Federal Financial Management Improvement Act is just beginning to unfold. That act required that for the audits beginning in fiscal year 1997 the auditors judge agencies' implementation with accounting standards and systems requirements and make an independent determination. During the first year, these last round of audits most of the agencies failed to meet that test and were found to not be in substantial compliance with those requirements. The legislation calls for a structured process where the agency heads produce remedial action plans to bring them into compliance with the 3-year timeframe established in that legislation.

Those remedial plans by the agencies will be available soon for the Congress to review and for GAO to look at in order to assess whether or not those plans are appropriately on target and are going to bring about the changes within the timeframe established by that legislative mandate.

Now going beyond these actions, we think the Congress could provide additional active oversight through the normal appropriations, authorization and oversight processes. For example, in this manner, agency heads should be required as they're presenting their funding request for next year's appropriations to explain how well they accounted for last year's appropriation. And for the problems being raised by the audit, and what is being addressed by them in terms of action plans and who the accountable people are that are responsible for bringing about the changes. And that action, requiring the agency head to come before a committee and have to explain the results of these audits, I think would be a powerful incentive to agency heads to make sure that the changes are taking place, and that they work to bring in the right senior management team including a good qualified chief financial officer to make needed changes.

Then the Congress could also hear the independent views of the auditors on what kind of progress is being made, what kind of actions have been taken, and what are the depth and severity of the correct problems. Then based upon this assessment, the Congress could take tailored actions on a case-by-case basis for each agency and consider a wide range of options. I think the tenet of Congressman Neumann's proposals to use the appropriation process is a good one, and we would suggest that it be used on a case by case basis. The Congress could decide, depending on the severity of the problems, to mandate a specified level of improvement within a certain timeframe or basically withhold or reserve appropriations until that takes place over a period time. They could also specify that the appropriations would be for administrative operations that would be withheld until the agency demonstrates a level of progress.

The Congress could also expand or limit agencies' reprogramming or transfer authority depending upon the quality of their financial management and the confidence that the Congress has in their ability to carry out effective financial management. Also, the Congress could begin to scrutinize more the funding requests that are made by agencies. If they don't get adequate answers to questions that are raised by the underlying problems with the data supporting the justification for the request, they could limit funds and also make sure that agencies are adequately able to explain how they're going to properly account for those expenditures.

Congress could also, in this circumstance, target or set aside money for specific financial management improvements to make sure that the appropriate resources are being applied, and then also require reports from the agencies on what kind of return they're receiving for that investment, and ask: is the money producing the appropriate results.

This type of process is intended to get at the issues that Congressman Armey and Congressman Neumann raised of determining accountability by using the appropriation process and the oversight process as the vehicle for examining and doing these detailed assessments and putting in the time and effort to do that.

In closing, Mr. Chairman, I would like to raise one huge caveat with this whole process. That caveat is the year 2000 computing challenge. Unless that problem is successfully dealt with, I think there's a high level of likelihood that financial management reforms will be derailed, or the pace of improvement slowed. As we've reported as recently as a week ago before this committee, agencies have been slow to make those changes. This committee needs no introduction to that issue. It's a serious problem with important ramifications, and I think appropriately is taking precedence as the top management problem in the agencies. And I'm concerned, unless agencies work that process through effectively and can ensure compliance with the year 2000 problem, efforts to achieve financial management reform and indeed other management reforms as well. We've made numerous recommendations to individual agencies, OMB and the President's Council on Year 2000 conversion in order to bring about the type of changes that will make this transition to the millennium successful.

But it's really critical, and I think the efforts of this committee to look at the incentives that should be put in place to bring about financial management reform need to consider that impending crisis and the efforts required by the agencies to do this. Now I'm not saying progress isn't possible. I think it's possible for agencies to deal with this problem successfully if they put forth the effort and implement the recommendation we and others have made. I think they can continue to make progress in financial management reform at the same time, but it's going to take a lot of effort, and it's definitely a complicating factor right now. We at GAO remain committed to working to bring about the type of accounting that the American public expects and to have proper accountability for the taxpayer resources and to also ensure that there are not widespread disruptions posed by the year 2000 problem in this transition to the next century.

That completes my remarks. Phil, Jeff, and I would be happy to answer any questions.

[The prepared statement of Mr. Dodaro follows:]

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss ways the Congress can help ensure that agencies effectively implement federal financial management reform legislation. This legislative framework includes the 1990 Chief Financial Officers (CFO) Act, as expanded by the 1994 Government Management Reform Act, as well as the 1996 Federal Financial Management Improvement Act (FFMIA). These statutes establish a broad-based set of expectations for improving financial management such as producing reliable financial reports, generating sound cost and performance information, fixing weaknesses in systems and controls, and building effective financial management organizations.

An essential foundation to help achieve these goals is the requirement that the 24 CFO Act agencies annually prepare financial statements and subject them to an independent audit, beginning with those for fiscal year 1996. Additionally, audited consolidated financial statements for the U.S. government are now required annually, starting with those for fiscal year 1997. To further promote needed reforms, FFMIA calls for agencies to meet various financial management standards and requirements and, if they do not, to prepare remediation plans.

These reforms begin to subject the federal government to the same fiscal discipline imposed for years on the private sector and state and local governments. This discipline is needed to correct long-standing serious weaknesses in federal financial management systems, controls, and reporting practices. Considerable effort is underway across government to make needed improvements and progress is being made, but a great deal of perseverance will be required to fully attain the legislative goals set by federal financial management statutes.

To build upon these efforts, the Subcommittee is exploring ways to expedite fixing the problems that hamper effective financial management across government today. The Subcommittee's efforts are in concert with the House of Representatives resolution (H.Res. 447), passed on June 9, 1998, which underscored congressional demands for quickly resolving outstanding financial management problems.

The federal government can continue to make progress in implementing financial management reforms, but the pace and extent of improvement will depend upon the dedication of agency heads and their senior management teams, especially the Chief Financial Officers, and the ability to deal with a range of financial management systems issues, as well as continuing emphasis by the Congress on financial management reform. Broad oversight by the Congress will be very important to hold agency heads accountable for needed financial management improvements. The Congress would make a significant contribution to ensuring satisfactory results in this area if the results of financial audits and needed improvements became a routine part of its normal annual appropriation, authorization, and oversight deliberations.

PROGRESS IS BEING MADE

Since the CFO Act's passage, steady progress has been made in improving federal financial management. A set of comprehensive accounting standards has been completed by the Federal Accounting Standards Advisory Board (FASAB), agencies are progressing in receiving unqualified audit opinions on financial statements, and structures are in place to identify and resolve governmentwide financial management issues.

FASAB was created by the Secretary of the Treasury, the Director of Office of Management and Budget (OMB), and the Comptroller General in October 1990 to consider and recommend federal accounting standards. Treasury, OMB, and GAO then decide whether to adopt the recommended standards; if they do, the standards are published by OMB and GAO and become effective. Statements of federal financial accounting concepts and standards, which are listed in attachment I, now provide for reporting on the federal government's financial condition, as well as on the costs of its programs.

For fiscal year 1996, when agencywide financial statements were required across government for the first time, 6 of the 24 CFO Act agencies received unqualified audit opinions. For the next year, fiscal year 1997, 9 agencies received unqualified audit opinions, and OMB expects an additional agency to receive an unqualified opinion by the end of June 1998.[1] The preparation of financial statements and independent audit opinions required by the expanded CFO Act are bringing greater clarity and understanding to the scope and depth of problems and needed solutions.

Some individual agencies have successfully solved these problems. For example, the Social Security Administration (SSA) prepared financial statements for fiscal year 1987--prior to the expanded CFO Act's requirement--addressed financial weaknesses, and attained its first unqualified audit opinion for fiscal year 1994. As this Subcommittee heard at its April 17, 1998, hearing, SSA now

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[1]These agencies are the Social Security Administration, the National Aeronautics and Space Administration, the Nuclear Regulatory Commission, the Department of Energy, the General Services Administration, the Department of Labor, the Small Business Administration, the Environmental Protection Agency, and the Department of the Interior. OMB expects the Department of Education to receive an unqualified opinion by June 30, 1998.

produces financial statements within 2 months after the close of the fiscal year and continues to receive unqualified audit opinions annually.

At the Department of Energy, the Inspector General identified problems related to the balance sheet Energy prepared for fiscal year 1995. The problems, for example, involved identifying liabilities associated with environmental cleanup and controls over property and equipment, which Energy worked to correct. The following year, fiscal year 1996, Energy prepared agencywide financial statements that received an unqualified opinion, and sustained these results for fiscal year 1997.

Many people are actively working to resolve federal financial management problems. For example, OMB has issued guidance to agencies on producing useful financial reports that meet FASAB standards. In addition to individual CFOs working to address issues in their agencies, the CFO Council, working with OMB, develops an annual financial management status report and five-year plan. Inspectors General are carrying out their responsibilities to ensure annual audits of financial statements.

REACTION TO THE FIRST GOVERNMENTWIDE FINANCIAL STATEMENT AUDIT RESULTS

On March 31, 1998, the Secretary of the Treasury, in consultation with the Director of OMB, issued the 1997 Consolidated Financial Statements of the United States Government. These audited governmentwide financial statements were the first prepared and issued under provisions of the expanded CFO Act and included our first report required by the act.[2]

On April 1, 1998, we testified[3] before this Subcommittee on the results of our audit. Our testimony framed the most serious financial management improvement challenges facing the federal government. In summary, significant financial systems weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, prevented the government from accurately reporting a large portion of its assets, liabilities, and costs. Our audit of the federal government's consolidated financial statements and the Inspectors General audits of agencies' financial statements have resulted in an identification and analysis of deficiencies in the government's

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[2]Financial Audit: 1997 Consolidated Financial Statements of the United States Government (GAO/AIMD-98-127, March 31, 1998).

[3]U.S. Government Financial Statements: Results of GAO's Fiscal Year 1997 Audit (GAO/T-AIMD-98-128, April 1, 1998).

recordkeeping and control system and recommendations to correct them.

The executive branch recognizes the extent and severity of the financial management deficiencies and that addressing them will require concerted improvement efforts across government. Financial management has been designated one of the President's priority management objectives, with the goal of having performance and cost information in a timely, informative, and accurate way, consistent with federal accounting standards. Also, the administration has set goals for individual agencies, as well as the government as a whole, to complete audits and gain unqualified opinions.

To help achieve these objectives, the President issued a May 26, 1998, memorandum to the heads of executive departments and agencies on actions needed to improve financial management. The President's message points to several areas requiring agencies additional attention: practices related to the government's property, federal credit programs, liabilities related to the disposal of hazardous waste and remediation of environmental contamination, federal government employment-related benefits liabilities, and transactions between federal entities. These areas reflect the serious deficiencies that prevented us from being able to form an opinion on the reliability of the consolidated financial statements of the U.S. government.

The President's directive places additional accountability on agency heads, and gives OMB more responsibility for addressing these problems. Specifically, he has directed that:

-- OMB identify agencies subject to reporting under the President's memorandum and monitor their progress towards the goal of having an unqualified audit opinion on the governmentwide financial statements for fiscal year 1999.

-- The head of each agency identified by OMB submit to OMB a plan, including milestones, for resolving by September 30, 1999, financial reporting deficiencies identified by auditors. The initial agency plans are due to OMB by July 31, 1998.

-- The head of each agency submitting a plan provide quarterly reports to OMB, starting on September 30, 1998, describing progress in meeting the milestones in their action plan and any impediments that would impact the governmentwide goal.

-- OMB provide periodic reports to the Vice President on the agency submissions and governmentwide actions taken to meet the governmentwide goal.

Specific agencies, such as the Department of Defense (DOD), are also reacting to the results of the most recent financial audits. As we testified before this Subcommittee on April 16, 1998, material financial management deficiencies identified at DOD, taken together, represent the single largest obstacle that must be effectively addressed to achieve an unqualified opinion on the U.S. government's consolidated financial statements.[4] In response to DOD's unfavorable financial audit results over the last several years, the Secretary of Defense announced on May 15, 1998, that initiatives to improve the accuracy, timeliness, and usefulness of financial information are to be developed through the Defense Management Council. The Secretary has (1) instructed the Under Secretary (Comptroller) to oversee departmentwide efforts to improve the manner in which financial information is captured and reported in all DOD systems--not just its financial systems--and (2) directed the secretaries of the military departments, and other top DOD officials, to support the Under Secretary (Comptroller) in DOD's financial business practices reform.

Reactions such as these to address the problems identified through the first audit of the U.S. government's consolidated financial statements are positive steps. In the short term, the quality of the action plans agency heads submit to OMB in response to the President's directive will be critical. It is essential for these plans to define financial management problems precisely, establish specific strategies and corrective measures for resolving them, include implementation timeframes, fix accountability for needed actions, and be prepared in consultation with auditors. Moreover, our experience has shown that considerable hard work, commitment, and oversight will be necessary to translate planned steps into concrete improvements.

The aggressiveness with which agencies implement the action plans and pursue solutions to financial management problems will be a strong indication of whether agency heads have a sustained commitment to achieving financial management reform goals. Ultimately, agency heads and their senior management team have to be accountable for results. Again, the auditors have key roles in providing perspectives on actions needed to attain improvements and in assessing progress toward implementing the action plans.

YEAR 2000 COMPUTING CRISIS AND MODERNIZING FINANCIAL SYSTEMS

Federal agencies will have great difficulty meeting expectations for modernizing their financial management systems unless they

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[4] Department of Defense: Financial Audits Highlight Continuing Challenges to Correct Serious Financial Management Problems (GAO/T-AIMD/NSIAD-98-158, April 16, 1998).

effectively meet the Year 2000 computing challenge.[5] As we have discussed in numerous testimonies before this Subcommittee, this issue is the most sweeping and urgent information technology challenge facing organizations today. Strong leadership is needed to avoid major disruptions in services and financial operations, such as processing financial transactions, reporting financial information, controlling property, and collecting revenue.

Unless this issue is successfully addressed, serious consequences could occur. For example:

-- payments to veterans with service-connected disabilities could be severely delayed if the system that issues them either halts or produces checks so erroneous that it must be shut down and checks processed manually;

-- the SSA process to provide benefits to disabled persons could be disrupted if interfaces with state systems fail;

-- federal systems used to track student loans could produce erroneous information on loan status, such as indicating that a paid loan was in default;

-- IRS tax systems could be unable to process returns, thereby jeopardizing revenue collection and delaying refunds; and

-- the military services could find it extremely difficult to efficiently and effectively equip and sustain U.S. forces around the world.

This Subcommittee's emphasis has helped to focus on the potential consequences of the Year 2000 computing crisis and the need for added impetus by some agencies to overcome vast difficulties within the next 18 months. In our most recent testimony before the Subcommittee on June 10, 1998, we reported that progress in addressing Year 2000 continues at a slow pace, and that as the amount of time to the turn of the century shortens, the magnitude of what must be accomplished becomes more daunting.[6] We have

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[5]For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data storage and reduce operating costs. In this format, however 2000 is indistinguishable from 1900 because both are represented as "00." As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

[6]Year 2000 Computing Crisis: Actions Must Be Taken Now to Address Slow Pace of Federal Progress (GAO/T-AIMD-98-205, June 10, 1998).

issued over 40 reports and testimony statements detailing specific findings and recommendations related to the Year 2000 readiness of a wide range of federal agencies. Moreover, to reduce the risk of widespread disruptions, we have made several governmentwide recommendations to the President's Council on Year 2000 Conversion and OMB to expedite the efforts of federal agencies and build strong partnerships with the private sector and state and local governments.

This will likely affect the pace of progress on modernizing financial systems, as some agencies' efforts to address the Year 2000 computing crisis is taking precedence over longer-term financial management systems development and improvement initiatives. Unless successfully dealt with, this crisis presents the likelihood of new financial management systems weaknesses occurring, existing problems worsening, and on-going reform efforts being derailed.

CONGRESSIONAL OVERSIGHT IS KEY

Congressional attention is essential to help sustain the current momentum to implement financial management reform legislation. There are clear indications that the results of financial audits are beginning to attract increasing attention from various congressional committees.

One instance involves the audit of IRS's financial statements. During our first audits, beginning with fiscal year 1992, we identified serious problems and were unable to give an opinion on IRS's financial statements. The head of IRS was called before congressional committees in both the House and Senate on numerous occasions to explain the steps IRS was taking, and the progress it was making, to overcome them. On April 15, 1998, we testified[7] before this Subcommittee that after several years of concerted effort by IRS and GAO, we were, for the first time, able to conclude that IRS's custodial financial statements were reliable.[8] These positive results show that focused attention by the Congress and this Subcommittee on IRS's financial management has begun to improve information available to IRS management and to the Congress to help make decisions.

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[7]Internal Revenue Service: Remaining Challenges to Achieve Lasting Financial Management Improvements (GAO/T-AIMD/GGD-98-139, April 15, 1998).

[8]Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

In addition, issues raised by financial audits are beginning to prompt inquiries among various congressional committees, as exemplified by the following:

-- In its reports for the fiscal years 1997 and 1998 appropriations bills, the Subcommittee on Labor, Health and Human Services, Education and Related Agencies of the House Committee on Appropriations (1) set the expectation that the Departments of Labor, Health and Human Services, and Education work vigorously toward obtaining clean audit opinions, (2) questioned whether these agencies could properly exercise the substantial transfer and reprogramming authority granted to them under the appropriations act if substantial financial management reform progress had not been made, and (3) stated that in subsequent years it would consider the agencies' progress in making such reforms and obtaining clean financial statement audit opinions when scrutinizing requests for appropriations and in deciding whether to continue, expand, or limit transfer and reprogramming authority.

-- The Chairman of the House Committee on the Budget asked us to monitor the Forest Service's progress in improving the reliability of its accounting and financial data, which also contributed to a recent joint hearing before the House Committee on Resources, Committee on the Budget, and Subcommittee on Interior and Related Agencies, Committee on Appropriations, focusing on inefficiency and waste resulting from the Forest Service's lack of financial and performance accountability.[9]

-- After considering funding for DOD for fiscal year 1998, the Senate Armed Services Committee legislatively required DOD to prepare biennial financial management improvement plans that include a concept of operations for the financial management of the Department.[10] The first such plan is to be submitted to the Congress by September 30, 1998. In approving DOD's 1997 and 1998 appropriations, the Congress also put in place a legislative requirement to accelerate DOD's planned timetable for addressing long-standing problems in accurately and

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[9]Financial Management: Forest Service's Progress Toward Financial Accountability (GAO/AIMD-97-151R, August 29, 1997) and Forest Service: Lack of Financial and Performance Accountability Has Resulted in Inefficiency and Waste (GAO/T-RCED/AIMD-98-135, March 26, 1998).

[10]Financial Management: Comments on DFAS' Draft Federal Accounting Standards and Requirements (GAO/AIMD-97-108R, June 16, 1997).

promptly accounting for billions of dollars in disbursements.[11] Additionally, as part of DOD's 1999 authorization, the Senate Armed Services Committee has approved a requirement for DOD to provide a detailed annual report on the quantities and locations of DOD's multi-billion dollar investment in inventories and military equipment.

-- The Chairman of the House Budget Committee asked us to analyze the programmatic and budgetary implications of the financial data deficiencies enumerated by the auditors' examination of the Department of the Navy's fiscal year 1996 financial statements. In March 1998, we advised the Chairman that the extent and nature of the Navy's financial deficiencies identified by the auditors, including those that relate to supporting management systems, increases the risk of waste, fraud, and misappropriation of Navy funds and can drain resources needed for defense mission priorities.[12]

-- On April 24, 1998, this Subcommittee and the House Committee on Commerce's Subcommittees on Oversight and Investigations, Health and Environment held a joint hearing on the Department of Health and Human Service Inspector General's audit of the Health Care Financing Administration's fiscal year 1997 financial statements. This helped focus attention on fixing the control weaknesses associated with the more than $20 billion of improper payments in the Medicare fee-for-service program disclosed by the financial audit.

-- In February 1998, we assisted the Chairman of the House Committee on the Budget consider the possible program and budgetary implications of the questions raised about financial statement data deficiencies identified in the Department of Transportation Inspector General's audit report on the Federal Aviation Administration's fiscal year 1996 Statement of Financial Position.[13]

In addition to initiatives by individual congressional committees, the Federal Financial Management Improvement Act provides the Congress another tool in monitoring the progress of all 24 CFO Act

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[11] Financial Management: DOD Needs to Lower the Disbursement Prevalidation Threshold (GAO/AIMD-96-82, June 11, 1996).

[12] CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies (GAO/AIMD-98-56, March 16, 1998).

[13] Financial Management: Federal Aviation Administration Lacked Accountability for Major Assets (GAO/AIMD-98-62, February 18, 1998).

agencies in improving financial systems. The act is intended to increase accountability in federal financial management and develop systems with the capability to support FASAB standards. FFMIA also provides for an independent judgment by auditors of agencies' efforts to foster compliance with financial management improvement goals.

Under the act, agencies are required to comply with federal accounting standards, federal financial systems requirements, and the U.S. government's standard general ledger at the transaction level. This legislation also requires (1) auditors performing financial audits under the CFO Act to report whether agencies comply with these requirements and (2) if agencies do not comply, agency heads are to prepare remediation plans to bring financial management systems into substantial compliance within 3 years.

We reported in October 1997[14] that prior audit results and agency self-reporting all point to significant challenges that agencies must meet to fully implement these requirements. The majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and cannot provide reliable financial information for managing government operations and holding managers accountable. Auditors' reports for fiscal year 1997 agency financial audits are disclosing the continuing poor shape in which agencies find their financial systems. To date, the financial systems of only 4 agencies are reported to be in substantial compliance with the requirements and standards FFMIA specifies.[15]

The Congress can build further upon this structure by conducting annual hearings on each agency as part of the regular appropriation, authorization, and oversight process. Each year, congressional committees could review the results of agencies' most recent financial statement audits and FFMIA reports to gauge the progress agencies are making in improving financial management. Agency heads could be required to describe remedial actions being taken to address financial management problems identified by independent auditors.

Through this process, the Congress can, therefore, be in an informed position to assess progress in achieving legislative

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[14]Financial Management: Implementation of the Federal Financial Management Improvement Act of 1996 (GAO/AIMD-98-1, October 1, 1997).

[15]The agencies reported to be in substantial compliance are the Department of Energy, the National Aeronautics and Space Administration, the National Science Foundation, and the General Services Administration.

financial management improvement reforms, addressing the Year 2000 computing crisis, and meeting the President's financial statement audit goals. This would allow thorough consideration of the severity of an agency's financial management problems, the demonstrated commitment to improvement efforts, and the independent perspectives of the auditors on an agency's progress in responding to financial statement audit recommendations. Using the results of this assessment, the Congress can clearly determine accountability and tailor needed additional actions.

Based on the circumstances of individual agencies on a case-by-case basis, the Congress could, for example, consider whether to (1) in areas of special concern, require attainment of specified improvements within established milestones before certain funds supporting administrative operations or systems would be available for obligation, (2) expand, continue, or limit transfer or reprogramming authority depending on the quality of an agency's financial management, (3) target, or set aside, needed funding for financial management improvement efforts that are deemed necessary to achieve progress and require periodic status reports on the return for this investment, or (4) scrutinize funding requests, and perhaps consider limiting funds, in areas where agencies cannot provide satisfactory answers to questions raised about the quality of the data underpinning the request or their ability to properly account for the expenditures.

These mechanisms--sustained congressional attention as part of the normal oversight process and agency head accountability--are essential to continue to effectively implement the financial management reform legislative foundation the Congress has established. They are key elements of ensuring that agencies make the investment of time, talent, and resources necessary to achieve needed financial management improvements.

With a concerted effort, the federal government, as a whole, can continue to make progress toward ensuring full accountability and generating reliable information on a regular basis. Annual financial statement audits are essential to ensuring the effectiveness of the improvements now underway, and ultimately, to producing the reliable and complete information needed by decisionmakers and the public to evaluate the government's financial performance. They are also central to assuring taxpayers that their money is being used as intended and helping the government implement broad management reforms called for by the Government Performance and Results Act.

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

ATTACHMENT I

STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS AND STANDARDS

STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS (SFFAC)

Objectives of Federal Financial Reporting (SFFAC 1)
Entity and Display (SFFAC 2)

STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING STANDARDS (SFFAS)

Accounting for Selected Assets and Liabilities (SFFAS 1)
Accounting for Direct Loans and Loan Guarantees (SFFAS 2)
Accounting for Inventory and Related Property (SFFAS 3)
Managerial Cost Accounting Concepts and Standards (SFFAS 4)
Accounting for Liabilities of the Federal Government (SFFAS 5)
Accounting for Property, Plant, and Equipment (SFFAS 6)
Accounting for Revenue and Other Financing Sources (SFFAS 7)
Supplementary Stewardship Reporting (SFFAS 8)
Deferral of the Effective Date of Managerial Cost Accounting Standards for the Federal Government in SFFAS 4 (SFFAS 9)

INTERPRETATIONS

Accounting for Indian Trust Funds (Interpretation 1)
Accounting for Treasury Judgment Fund Transactions (Interpretation 2)
Measurement Date for Pension and Retirement Health Care Liabilities (Interpretation 3)
Accounting for Pension Payments in Excess of Pension Expense (Interpretation 4)

(919285)

Mr. HORN. OK. Let me just mention, first, would you give us your comments on Mr. Neumann's legislation and what else you might suggest, based on your experience in this area, so that we can all take a look at it before a markup is scheduled?

And No. 2, if you have any material on the Forest Service, since that's been mentioned? I am going to a couple of forests during the break in a few weeks and I would appreciate anything else you have, since I know you've done a series of reports, and get a set for the staff, and a set for me, and a set for the minority. And then we'll all know what's going on in that area without having to reinvent the wheel.

And now we're going to yield 10 minutes of questioning at a time and alternative between parties. I yield first to the gentleman from Ohio, the ranking minority member here.

Mr. KUCINICH. Thank you very much, Mr. Chairman, Mr. Dodaro, and associates. I want to welcome you to this committee, and thank you for the cooperation which you have given to this committee to assist us in our work.

I think it's important that the administration and the Congress work together to achieve fiscal accountability in the Government. As a matter of fact, that's the only way we're going to make it happen. I also would like to associate myself with the remarks of the chairman with respect to an analysis of the impact of Mr. Neumann's legislation. I think that as we heard his testimony, while much of it sounds plausible, put in the context of the Y2K problem and the immediate environment which we're dealing with, which the chairman has done an absolutely remarkable job, I'd have to say, in terms of highlighting to the American people, it may, in fact, be premature to impose an additional mechanism on the Government. We could be creating a veritable train wreck. So I'm glad that you brought that up, and I'm sure that Mr. Neumann who is very dedicated to efficiency and accountability in Government would want to respect the timing of such legislation.

So, again, your counsel and guidance on that is important. If you could expeditiously give us an analysis prior to this bill going in, it would be very helpful.

I'd like you to speak for a moment about the significance of the first ever audit. You know, we've heard discussions about it, but I think the American people may be incredulous about the claim that this was the first ever audit, and it was conducted by this administration. It almost sounds like it's just a purely political claim. Would you elaborate——

Mr. DODARO. Sure.

Mr. KUCINICH [continuing]. For us on that, and help to clarify that claim, and to give it some substance?

Mr. DODARO. I'd be happy to. I'd also ask Mr. Steinhoff to comment on that. Jeff has been involved in all the major pieces of financial management reform passed over the last decade.

But to put it in historical perspective, for many years GAO and others were trying to advocate that we have annual financial audits of our executive branch agencies similar to what is done in the private sector, and it took us a number of years to get the original CFO Act passed in 1990.

That act allowed for a pilot program of audits of entire departments and agencies, 10 in total, because at that point the Congress was not convinced of the cost benefit of doing the audits across the Federal Government. It authorized audits of individual revolving funds and trust fund activities and commercial-type activities, but the notion of audits for entire departments and agencies was one that the Congress wanted first to run a pilot program, much like the pilot programs in the Government Performance and Results Act. So that was done.

In 1994, GAO, OMB, and others agreed that the value of these financial audits were very important in bringing about management changes in the Government. We knew that there were a lot of problems in the Government, but I don't think anybody realized the depth and scope of the problems until we embarked as a Government on these first sets of financial audits for fiscal year 1996 when the Congress required all 24 CFO agencies to have audits covering their entire departments and operations. That was authorized by the Government Management Reform Act of 1994.

Also, I think it was instructive to point out that the Government Management Reform Act allowed OMB to give waivers for departments and agencies for those fiscal year 1996 audits. I was pleased to see OMB did not grant any waivers, and that got us off to a good start across Government in getting these audits conducted and put us in a position to then move into fiscal year 1997 and have another set of audits of the 24 agencies. Then, by law, that was also the first year where the Secretary of Treasury in consultation with the Director of OMB was required to produce, and GAO required to audit, consolidated financial statements of the Federal Government.

So, it's been a long process to get these requirements in place. While the audit results are staggering, and in many cases not totally unknown, but I also think they are instructive because they finally are bringing together, in one comprehensive framework, the major problems that need to be addressed. I was pleased to see that the President's directive embraced those major deficiencies and required agencies to develop plans to address them. So the process now is getting in a routine fashion, which it has to be.

I'd also put it in the perspective of the testimony I gave before this committee at IRS. IRS was 1 of those 10 pilot agencies required to have audits by the 1990 act. And we worked at this. This committee held hearings year in and year out. The head of the IRS came up to this committee, explained what the problems were, and what they were doing to fix it. Finally after 6 years of dedicated effort, we were able to give IRS a clean opinion on their custodial financial statements. That is the type of process that has to take place at each of these major departments and agencies.

Mr. KUCINICH. If I may—do you think that most agencies are working hard to resolve their audit problems?

Mr. DODARO. I think most agencies are taking the problem seriously and are trying to work on them.

Mr. KUCINICH. They're serious about receiving clean opinions? Does that mean anything? If we're looking at the first every audit just recently, has this really been communicated to all agencies that this is serious? Is that the sense in your contact with agencies?

Mr. DODARO. I think——

Mr. KUCINICH. That they're serious?

Mr. DODARO. We have a large and diverse Government, and there has not been unanimity across all the departments on the significance of this issue. So I wouldn't want to mislead the committee to say that all agencies are taking it with the same degree of interest. I do believe most agencies are taking it seriously and are committing the necessary time and attention. That's why you see continued progress in the number of unqualified opinions. You mentioned nine for this year; for fiscal year 1996 it was six. So we are moving in the right direction.

The Department of Defense is really beginning to show more interest than they have been before in this arena. The Secretary of Defense issued a directive for the first time to all the major heads of DOD and the military services that he expects them to be involved in fixing this problem and in working with the Chief Financial Officer over at DOD.

Mr. KUCINICH. That's instructive, and I think it would be good to know that that's happening everywhere, because the word has to come from the top. If it doesn't, the chances of having a clean audit opinion would probably be unlikely. So, I know that you will communicate that to those who you speak to, but I also think it would be good for you to be working with this committee and our staff of both majority and minority side to let us know if any of the agencies need a little bit of encouragement or if there's some obvious lack of compliance, because we shouldn't have to wait to have the information come out in the full committee if we need to have a letter co-signed by myself and the chairman in order to establish the position of the committee directly to an agency head. We're willing to do that. I mean we need a cooperative and working relationship here. So I just wanted you to communicate that.

Thank you, Mr. Chairman.

Mr. DODARO. Mr. Kucinich, let me just add if I might, Mr. Chairman, one additional suggestion.

In addition to the arrangement that Congressman Kucinich mentioned of working cooperatively with the executive branch, I would recommend actively engaging the appropriations and the authorizing committees for those agencies. I think the message, if heard from this committee and the appropriators that have responsibility for giving money to these agencies, and we will see more and more attention to fixing problems. There's some examples of where committees have mentioned in appropriation language the importance of getting clean opinions and their concerns about this. The Budget Committee has asked us several times, too, to provide analysis the significance from a programmatic and budgetary standpoint of the Forest Service, for example getting an adverse opinion?

So there's beginning to be more interest, but to the extent to which this committee could foster more attention to that, I believe that would provide more incentives for the agencies if they hear it from the multiple committees that they work with.

Mr. HORN. I think that's an excellent idea, and we will certainly followup because certainly the ranking member and myself would do it. But now we'll add four other signatures, the ranking member, and the chair of an Appropriations subcommittee and the Authorization Committee. And I think that would get the message over pretty readily that we're all on the same team here.

Mr. DODARO. Yes.

Mr. HORN. Good; that's a very helpful suggestion.

I yield myself 10 minutes to go through a few of these questions just for the record.

What are some of the important actions—and you've mentioned a few, and I've mentioned a few, and the ranking member has mentioned a few—the critical factors that are needed to make sure that the Presidential memo is implemented effectively and timely? Is that followup coming from the Director of OMB, or how are they working that? Who's pinned with responsibility to educate the cabinet officers that the President is serious?

Mr. DODARO. Yes. I'll ask Jeff to expand on this a little bit, but the Presidential memo clearly indicates that it gives more responsibility to the Director of OMB for carrying this out with the department heads and agencies. In fact, the memo gives the Director of OMB the discretion to decide which departments must submit plans and which ones do not have to do that.

Jeff.

Mr. STEINHOFF. Basically, what you're seeing here is direct accountability being placed on the department head and a very clear accountability being placed on OMB. If you look back at the CFO Act when it was passed in 1990, it did envision the Deputy Director of Management carrying out this "M" role, and the Presidential memo is really reinforcing this.

The other important factor, to kind of build on the response that Mr. Dodaro gave a few minutes ago, is that this has engendered some of the response we see today. This has been a long road. The Hoover Commission back in 1950 called for improved financial reporting others have called for improvements for many years. But budget was key, and people largely viewed that all the accounting and accountability was done through the annual budget.

What really turned the corner is in 1986, Senators Roth and Glenn introduced a bipartisan bill. And while it didn't get through, it began the process. In 1990, the CFO Act became law. I think many people thought it would come and go. There was a pilot program; they thought they'd wait it out.

But in 1994, when GMRA passed, people all of a sudden said, "Gee, these folks are serious here. They want something done and it's transcended administrations and transcended Congresses."

So with that intensive focus now for the past dozen years, I do believe that people have gotten the message, and people are trying in earnest to get the job done, and you will see attention being placed on the Presidential memo.

Mr. HORN. Well, that's a very helpful statement, and we'll put it to good use. I noticed Mr. Schatz is advocating the Office of Management just as we are, and that bill will go in shortly. And I think all of those authorities that have been given the Deputy Director of OMB for management would be transferred then to this Director reporting directly to the President. So, at last the President has a group of people around him that would know something about management, and not just simply be immersed in the budget which is still going to be a major activity for any President over the next 20 years until we reduce the national debt from its $5.3, .4, .5 trillion burden on the economy.

Mr. DODARO. Mr. Chairman, in implementing this memo it will be very instructive to see what the quality of these plans are at the end of July, coming from the heads of the agencies to OMB. That will be a good signal as to what extent or how seriously the agency heads are taking the problem. In addition to the time and effort that goes into developing those plans, the followup will be required. I point that out in my written statement, but I think we're off to a good start. But as we've seen before, without sustained attention, these issues become overwhelmed by other matters.

Mr. HORN. You mentioned, Gene, the year 2000 problem. Now do we face the situation where that problem is so overwhelming that it will consume all of the resources that we might want to apply, or a cabinet officer might want to apply, to fixing the financial management systems? And will that simply divert them away from fully implementing the Chief Financial Officers Act and the Federal Financial Management Improvement Act?

Mr. DODARO. It's going to vary by agency, but there's no question in my mind, in some agencies that that is going to happen of necessity. The potential consequences of failure in the year 2000 problem, and the consequences that it could have on American citizens—for the delivery of services, national security, public safety and health—are enormous as we've outlined with this committee before. There's a very real possibility that would happen.

If for a minute, also, you think about your grades that this committee has given on the year 2000 issue along with these agencies have received disclaimers of opinion, you can see that, in many cases, the same agencies are receiving lower marks for both problems.

The Department of Defense is a good example. Other agencies that are getting clean opinions, like Social Security Administration you've rated high on the year 2000 problem. So in some agencies it's going to be possible for progress to continue in both areas. But in other areas where you've got significant problems in financial management and in dealing with the year 2000 issue, and other management problems, there's no question that the competition for resources will be key. The competition for management attention will be key, and in the short run, the year 2000 problem has the more drastic consequences if not dealt with effectively.

Mr. HORN. So we really have no choice in a world with limited resources, we've got to really devote most of those to solving the year 2000 problem?

Mr. DODARO. I believe so.

Mr. HORN. As we've noted in numerous hearings of looking at various agencies here, and I noticed Mr. Schatz has done it in his prepared testimony, that we have a little problem in some agencies where both either the CIO and CFO are also the Assistant Secretary's for Management? Does the General Accounting Office have any views on that question as you roam around the executive branch? Is that a problem?

Mr. DODARO. Yes, it is a problem. We have pointed that out on several occasions. There are about four or five agencies where they have joint responsibilities. We think that both problems are so significant that it requires full-time attention and having qualified people that are dedicated to both of those issues. So, we've raised that issue to the administration repeatedly. They've said that they're going to take a look at that issue and move to separate those responsibilities, but it hasn't happened yet in a number of agencies.

Mr. Schatz points out a very good point there. And we're on record in prior testimony before this committee and others that having the same person vested with CFO and the CIO responsibilities, particularly in large departments and agencies, really is not an effective way to implement the legislative reforms that are drastically needed in both areas.

Mr. HORN. Yes, I agree. Both of these are 18-hour-a-day jobs, and the fact is, when you're in holding both, as we've had it with Muñoz in Treasury, which is the first one that excited my interest. I would ask that the staff director, Mr. George, put the appropriate language in for the next train leaving the station that becomes law, and let's just order that and quit messing around hoping sweet reason will work. I can only take Lyndon Johnson's, "As we reason together," view for only so long when nothing happens. So let's do it in law.

Mr. DODARO. I would endorse that, Mr. Chairman.

Mr. HORN. It's my understanding that the bar against which the agencies are measured—that is the accounting standards which they must meet—was significantly increased for fiscal year 1998, with the adoption of new standards for cost accounting, accounting for revenue, accounting for property plant, equipment, and stewardship reporting. Do you anticipate that any agencies that have received clean or even qualified opinions in fiscal year 1997, will be unable to do so in the current fiscal year we're in which is 1998?

Mr. DODARO. I'm going to ask Mr. Calder to respond to that question. Phil has been deeply involved in the setting of these new accounting standards for the Federal Government. He brings a very unique perspective of having a 30-year successful career in the private sector auditing private-sector organizations as well as State and local governments. So, I'm very pleased to have Phil as our Chief Accountant. He has some good views, I know, on that issue.

Mr. HORN. Great. Proceed, Mr. Calder.

Mr. CALDER. Well, the question is a good one. There certainly are new regulations, new accounting standards that will have to be met, and in some cases it will be difficult for some departments to meet those. Much of this is brand new. FASAB, the Standards Board, and the agencies are working together in an attempt to help the agencies understand what the intent of the accounting regulations are, and also to consider the regulations themselves. It appears that there are some cases where the standards may have called for more than might be necessary so that there is no attempt being made to downgrade the accounting standards. There is an attempt to reconsider all of them to make sure the standards call for the appropriate amount of information.

As we harmonize the abilities of the departments and the needs for information, I think there will be some relief in terms of that particular problem, but there are those agencies which have gotten a clean opinion which are going to have to do more work to continue to get the clean opinion.

Mr. HORN. Well, we thank you.

Any additional comments from the gentleman from Ohio?

Mr. KUCINICH. Thank you, Mr. Chairman.

Mr. DODARO. And we'll be pleased to provide the comments on Congressman Neumann's bill.

Mr. HORN. Good.

Mr. DODARO. And we'll also get you a nice summary of the Forest Service issues with the backup material.

Mr. HORN. Yes, to save our Xerox budget, why don't you send one directly to the ranking member, and one to me, and one to Mr. George?

Mr. DODARO. We will do that.

Mr. HORN. We'll have covered all the bases by that time.

Mr. DODARO. We'll always send one extra set, too. [Laughter.]

Mr. HORN. OK. We thank you for your usual fine statement.

I'm interested, Mr. Steinhoff, you're noted here as Director on my agenda. That would be Director of what, just for the record?

Mr. STEINHOFF. I'm Director of Planning and Reporting.

Mr. HORN. Planning and Reporting?

Mr. STEINHOFF. In the Accounting and Information Management Division.

Mr. HORN. Did you remember we held a hearing on the Benchmark Program in Oregon which fascinates me? Have you had a chance to look at that and how that works in the Oregon State government? To my knowledge, it's the only State that has a Benchmark approach to looking at the effectiveness and efficiency and goal-reaching of various State programs.

Mr. STEINHOFF. I am familiar with some of the things they've done. I'm not really particularly familiar with that particular issue.

Mr. HORN. Well, if you have some knowledge of it or anybody on your staff or anywhere we could find them, we would welcome them, because I'm very interested in pursuing that and spelling it out for the executive branch. We should be doing exactly what Oregon is doing.

Mr. DODARO. We have people——

Mr. HORN. They talked to the clients; they asked them what they wanted, what they expected, how would we know something when it was achieved, and so forth and so on.

Mr. DODARO. Yes, we have people at GAO that have followed the development of that, Mr. Chairman. Also, we have very active, good relationships with the State auditors and others out there who are living with that on a daily basis. We have talked with the city auditor of Portland, for example.

Mr. HORN. Well, if GAO could do us a little summary——

Mr. DODARO. Sure.

Mr. HORN [continuing]. Of what's going on in the States on this, it makes some sense in terms of applicability to the U.S. Government and its various programs. That would be most helpful.

Mr. DODARO. Yes, we will do that.

Mr. HORN. Thanks for your usual fine testimony. Thanks for coming.

Mr. DODARO. Thank you, Mr. Chairman.

Mr. HORN. Now we'll go to panel three. And it might be panel three, but it only has one person in the panel. And I guess we figured we didn't need anybody else. Mr. Schatz and the Citizens Against Government Waste have a very good reputation.

Mr. HORN. I think you know the routine here, Mr. Schatz.

[Witness sworn.]

Mr. HORN. Affirmed the oath, the clerk will note. And your statement is automatically part of the record. And we're glad to have you here. So, proceed.

STATEMENT OF TOM SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

Mr. SCHATZ. Thank you very much, Mr. Chairman.

And let me state at the outset that Citizens Against Government Waste does not take any Federal funds, wouldn't want any, and that we operate with our membership and other supporters throughout the country.

Congratulations on continuing the effort to bring more accountability to the use of our tax dollars in Washington, both to you, and the ranking member, and the other members of the subcommittee, and certainly to the Congress for last week reinforcing the need to do something more about how we're looking at our money.

We've had studies for many, many years. Mr. Steinhoff mentioned the Hoover Commission. Of course, Citizens Against Government Waste arose out of the Grace Commission and has been working on these issues for many years. In fact, I worked with Jeff Steinhoff on that 1986 bill that formed the basis for many of the changes that have occurred since then. The fundamental underpinning of that bill was the establishment of an Office of Federal Management which was recommended by the Grace Commission and others like Citizens Against Government Waste. In fact, former Congressman and White House Chief of Staff Leon Panetta once had such a bill. I don't know what happened when he went over to the White House, but it is something that deserves attention, and I'm glad to hear that you are seriously considering it, and that it is a clear—now with the year 2000 problem—situation that has to be addressed.

While the year 2000 problem, in and of itself, is significant, it's also helpful in drawing attention to these management problems. As often happens, it takes a crisis of sorts to make people move a little faster in terms of resolving problems. And if that's the incentive needed to address and solve a lot of the management problems throughout the Federal agencies, then it's something that we welcome in a strange sense. In fact, there may be some people that welcome the year 2000 problem because it may shut down some agencies, but I don't think that's what we really want to happen.

Now it seems to me, based on the testimony today, and I certainly associate myself with the importance of the issue and many of the recommendations made by the former witnesses that have spoken this morning, I think we need a series of incentives and oversight and consequences, and then also communication.

The incentives are simply to reward Federal workers for doing the right thing, for fixing the problems, for coming up with solutions. That was one of the recommendations that was made by the Grace Commission to actually provide support for incentives, particularly in the areas of financial management and cash management, to Federal employees that do the right thing and move these recommendations and processes forward.

Second, oversight. Mr. Chairman, you have really, really done a wonderful job on an issue, as many people including Mr. Armey have pointed out, that does not grab the headlines except when you find those—or actually lose those—[laughter]—missile launchers and other components in the Defense Department. While these are things that need to be brought up to draw attention to the problem, certainly everyone wishes that they weren't there in the first place.

The consequences, as illustrated by Mr. Neumann's bill, should be very strong. Sometimes it does take something extra to get people to move on this issue. The incentives in Washington have always been to spend the money, not necessarily to worry about how it's being spent. In fact, one of the things that was described in terms of the Federal loan program is that money gets lent to people who can't afford to pay it back, and then they don't keep track of where it goes. In those days, it was money the Government didn't have. Now, at least, we have this alleged surplus. But that's still not an excuse to spend money or loan money and not keep track of it and not try to get it back in the proper fashion.

Finally, communication; continuing the oversight, continuing the hearings, keeping this issue out front of the American people. While we certainly appreciate what the Congress did last week and what the President has done with his Executive order, I think this is such a serious problem and such a significant one. The administration has certainly been up front about discussing technology, and there has been some, I think, very valid criticism of the Vice-President for not taking a stronger lead in this area. They should be talking about this every single day.

There is a countdown going on right now to the end of literally next year. That's not that far away. If the message were to get out in terms of followup to the President's order, it's something that he should be talking about at every press briefing, at every opportunity he has to discuss any kind of issue in relation to Federal spending, because we're not going to have the ability to spend some of that money if those systems are not fixed. I'm not sure that that is fully recognized throughout—not just in Washington and at the heads of the agencies, but also by the public.

And we need a lot more support. The vote last week should have been front-page news. It should be discussed by every Member of Congress when they go back home. You know, that is a bipartisan and very important effort to bring more accountability. And there is nothing that people appreciate more right now when they know in some ways that they're kind of overpaying because we do have more money coming in than we're spending. They want solutions, and they want accountability. And I think that's something that should be clearly communicated by all the Members of Congress as we move ahead.

One more thing I would add. Mr. Kucinich, you mentioned whether we should be moving forward with Mr. Neumann's bill or whether there's a problem or question. The agencies have really, in a sense, had 5 years—and really more—to get their books in order. This is something that's been done by Executive order. It's been discussed. There are a lot of things out there that have pushed in this direction. Certainly, the financial management, as GAO pointed out—and some agencies are moving ahead and with others it's a problem. I would simply add to the consequences of Mr. Neumann's bill, failing to fix the year 2000 problem.

In other words, don't back off from providing consequences and accountability, but add in what is certainly the biggest management problem we face in the next year and a half. They would certainly get the message there. "Fix it or you or someone else may be gone." So if we have to step there first, let's do that as opposed to maybe postponing the whole process of providing a real serious consequence as to failing to move ahead on management.

Now that concludes my oral statement, Mr. Chairman. I know you are going to include my written statement. I'll be happy to comment or answer any questions.

[The prepared statement of Mr. Schatz follows:]

CITIZENS
AGAINST
GOVERNMENT
WASTE

Testimony of Thomas A. Schatz, President
Citizens Against Government Waste
to the
Subcommittee on Government Management, Information and Technology
June 18, 1998

My name is Thomas Schatz and I am the president of Citizens Against Government Waste, a 600,000 member organization founded in 1984 by industrialist J. Peter Grace and columnist Jack Anderson. The organization was founded to implement the findings of the President's Private Sector Survey on Cost Control, commonly known as the Grace Commission.

In March of this year, the General Accounting Office released the *Consolidated Financial Statements of the Federal Government.* The 66-page audit report, mandated by the 1994 Government Management and Reform Act, reveals in unmistakable terms the chaotic nature of the federal bureaucracy. The report discloses that few agencies can stand the scrutiny universally required of private sector businesses. Unfortunately, as many taxpayers have long suspected, no one is minding the government store.

The report indicates that billions of dollars in government property cannot be accounted for, including $636 billion in military equipment. Among the misplaced items are a surface-to-air missile launcher worth $1 million, two harbor tugs worth $875,000 a piece, 15 jet engines (including two priced at $4 million each), and a floating crane with an estimated value of $468,000.

The Pentagon wasn't the only contestant in this macabre game show. Auditors discovered that the Department of Housing and Urban Development is making approximately $900 million per year in overpayments on rent subsidies. Even worse, an investigation of the Health Care Financing Administration revealed that the agency made $23 billion in Medicare overpayments. And in a devastating critique of the government's technological capabilities, GAO found that only a handful of the agencies examined made progress toward fixing the Millennium Bug by the inexorable December 31, 1999 deadline. Some may cheer the prospect of a major government shutdown from failing to address this crisis, but the Year 2000 bug would spread its virus indiscriminately, hurting both useless and essential functions.

In all, the GAO report examined the financial records of 24 cabinet-level departments and government agencies, and had little good to say about most of them. Only seven — including the Social Security Administration, NASA, and the General Services Administration — received passing grades.

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The remainder received strong criticism for their accounting practices, with a few — the Defense Department among them — having financial statements so poor that GAO simply could not render a definitive opinion on their books.

Similar judgments in the private sector would spell doom for just about any corporation you could name. But not the federal government. Instead, the results of this unprecedented audit were greeted with a yawn by most lawmakers. A Clinton administration official shrugged off the audit as something akin to cleaning out an old closet after two hundred years.

Despite the comprehensive nature of the report, the audit did contain a few weaknesses. For instance, the report failed to list several key government assets and liabilities — among them nuclear warheads, national parks, and employee pension plans. Defense Department spokesman Kenneth Bacon summed up the problem when he asked, "How do you calculate the value of the U.S.S. Constitution sitting in Boston Harbor or the environmental liabilities of destroying in 40 or 50 years a nuclear-powered sub commissioned this year?"

The audit report also neglected to mention the mother of all government liabilities — future Social Security benefits. In fact, auditors indicated that the federal government could simply eliminate its Social Security liability by cutting future benefit payments! The report is a frank acknowledgment that the government remains unprepared for the impending bankruptcy of the Social Security trust fund in 2029.

Nonetheless, the audit remains an important tool in the fight against government waste. Congress and the White House allegedly remain committed to correcting the accounting flaws revealed by the audit and to obtaining a "clean opinion" by 1999. However, given the scope of the problem, it is questionable whether that goal can be reached. This much neglect simply cannot be cleaned up overnight.

Although several agencies have made remarkable progress toward financial accountability, most of them don't seem to take seriously their obligation to taxpayers. In 1984, the Grace Commission made 2,478 recommendations to improve the efficiency of the federal government. These proposals, once fully implemented, would have saved taxpayers $424.4 billion over three years. The recommendations covered all federal departments and most major agencies, as well as cross-cutting issues such as financial management, federal management systems, personnel, procurement, printing and publishing, and retirement.

One of the most important structural proposals made by the Grace Commission was to re-establish the Office of Management and Budget (OMB) as the Office of Federal Management (OFM). This would not simply restore the "M" to OMB, it would make the "M" the only letter in the President's primary agency in charge of carrying out and enforcing his management and spending plans. The Grace Commission noted that budgeting should be a tool of management, rather than the driving force for management, just as it is in the private sector.

The Commission also proposed the establishment of a chief financial officer (CFO) in the Executive Office of the President, an office of federal financial management at OFM, and counterpart CFOs in federal departments and agencies. In 1990, Congress passed the Chief Financial Officers Act, establishing a Deputy Director for Management at OMB, an administrator of a new office of federal financial management, known as the controller of the executive branch, and 23 CFOs at department and agencies. By the end of the Bush Administration, only 14 of the 23 CFOs had been appointed.

In the second term of the Clinton administration, most agencies have a CFO, acting or otherwise. However, four of these agency CFOs carry the additional title of chief information officer, and seven of the CFOs are also the directors of administration. This is clearly not in keeping with the original intent of the legislation – one individual, removed from politics, devoted to one job. Professional managers and auditors must be ensconced in these positions.

Rep. Neumann testified earlier regarding his Tax Dollar Accountability Act, which provides an enforcement mechanism and penalties for agencies that fail to pass similar audits in the future. His legislation gives agencies just one year to clean up their books. If the agencies are unable to comply, the responsible individuals will be fired, and five percent of the agency's funding would go into a reserve account until the agency is able to pass a financial audit. If this is what it takes to get results, then it should be adopted by Congress.

The audits are putting the agencies through a healthy exercise, which will also better enable them to implement the Government Performance and Results Act, another critical tool to provide greater accountability in the federal government. In the future, it is our hope that every taxpayer will receive, along with his or her tax forms, a fully audited financial statement of the federal government. Then they will be able to truly determine how wisely – or unwisely – their money is being spent.

Mr. Chairman and members of the subcommittee it is a pleasure to be here this morning, and I look forward to answering your questions.

Mr. HORN. Well, I mentioned in my comment to the General Accounting Office witnesses your testimony on supporting the Office of Management and also your views on having a separation between the Assistant Secretary for Management and the Chief Financial Officer, and also the Chief Information Officer. Now that makes a lot of sense to me, and we will be pursuing those as I think you know.

On the year 2000 problem, I think you're agreed certainly that a major emphasis has to be paid on that and, you know, focused on that because all else, if we don't correct that, is in absolute disarray.

Mr. SCHATZ. Well, we just found out, for example, Mr. Chairman, that our voice mail won't work——

Mr. HORN. Yes.

Mr. SCHATZ [continuing]. In the year 2000, and we only replaced it 3 years ago. So there are a lot of things that people don't realize will occur or have an impact on their daily business. We've become very dependent on this technology, and it is something that really needs to be moved quickly. The Government being the size that it is and having had really such poor financial management practices over the years has to, in a sense, set aside almost everything else, and look at this, and move forward as fast as they can.

Mr. HORN. Does your organization have any additional suggestions to put to Mr. Neumann's bill as to the consequences and responsibilities section in particular?

Mr. SCHATZ. Well, I think there is—it really starts in a good direction. I think there was one suggestion—and I don't know that's exactly in the bill—but the withholding of the funds should be from the administrative portion of the budget of the agency. In other words, you don't want people who are receiving services to suffer because the financial management is in trouble, and that is something that does affect how people work.

Now the other side of that, of course, is that sometimes it takes more money. One of the big things that has been a problem over the years is that members view the ability to fund programs as being a lot more interesting and a lot more exciting and it gets more headlines then when they say, "Well, we're fixing computers."

Again, with the year 2000 problem it may be OK and it may, in fact, be useful to run around saying, "We're going to make sure the Government doesn't shut down, therefore, we're going to put more money into fixing computers than we have in the past."

All the talk about the Government surplus, all this other money—to me you take whatever you've got that's extra, then you do this. You don't talk about it—more programs, and more spending, or anything else, or obviously Social Security is extremely important. But this is an area where spending the money will, in fact, produce results as long as it's followed up and as long as the accountability and oversight is there.

Mr. HORN. Does the gentleman from Ohio have any questions? If not, would any other comments you want to make, Mr. Schatz?

Mr. SCHATZ. Well, we're happy to work with you, Mr. Chairman. As you know, we take this issue so seriously that we have been working on it for many years. In fact, when I was looking for a new Director of Government Relations, when I saw that Council Nedd had worked on this subcommittee, aside from his many other qualities, that was a very important one for us because it did bring in someone who understood this and because it has been such a critical issue for me and the organization since I've been there since 1986 that we expected this to be something that would be, and continue to be, of importance. Certainly, the quality and knowledge that he brings to the table is reflected in the recommendations in this testimony.

We all look forward to continuing in this direction. We appreciate the bipartisanship and certainly hope that we can get this done so that on January 1, 2000, we won't be afraid to fly, and we'll get all the checks we're supposed to get.

Mr. HORN. Right. Well, we're glad to see Council in the room. So, thank you for coming and testifying.

I'm now going to thank the staff that worked on this hearing on both sides of the aisle. J. Russell George, the staff director and chief counsel, is behind me. Matthew Ebert, the clerk of the subcommittee; Dianne Guensberg is to my left and your right, on detail from the General Accounting Office; Mason Alinger, staff assistant, and a number of interns, Betsy Damus, Mark Urciuolo, and then David Graff for the majority. For the other side of the aisle, Faith Weiss, minority counsel, Jean Gosa, minority clerk; Earley Green, minority staff assistant, and Colin Newman is the court reporter.

So, we thank you all, and this hearing is adjourned.

[Whereupon, at 11:15 a.m., the subcommittee adjourned subject to the call of the Chair.]

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