The federal government's first audited governmentwide financial statements
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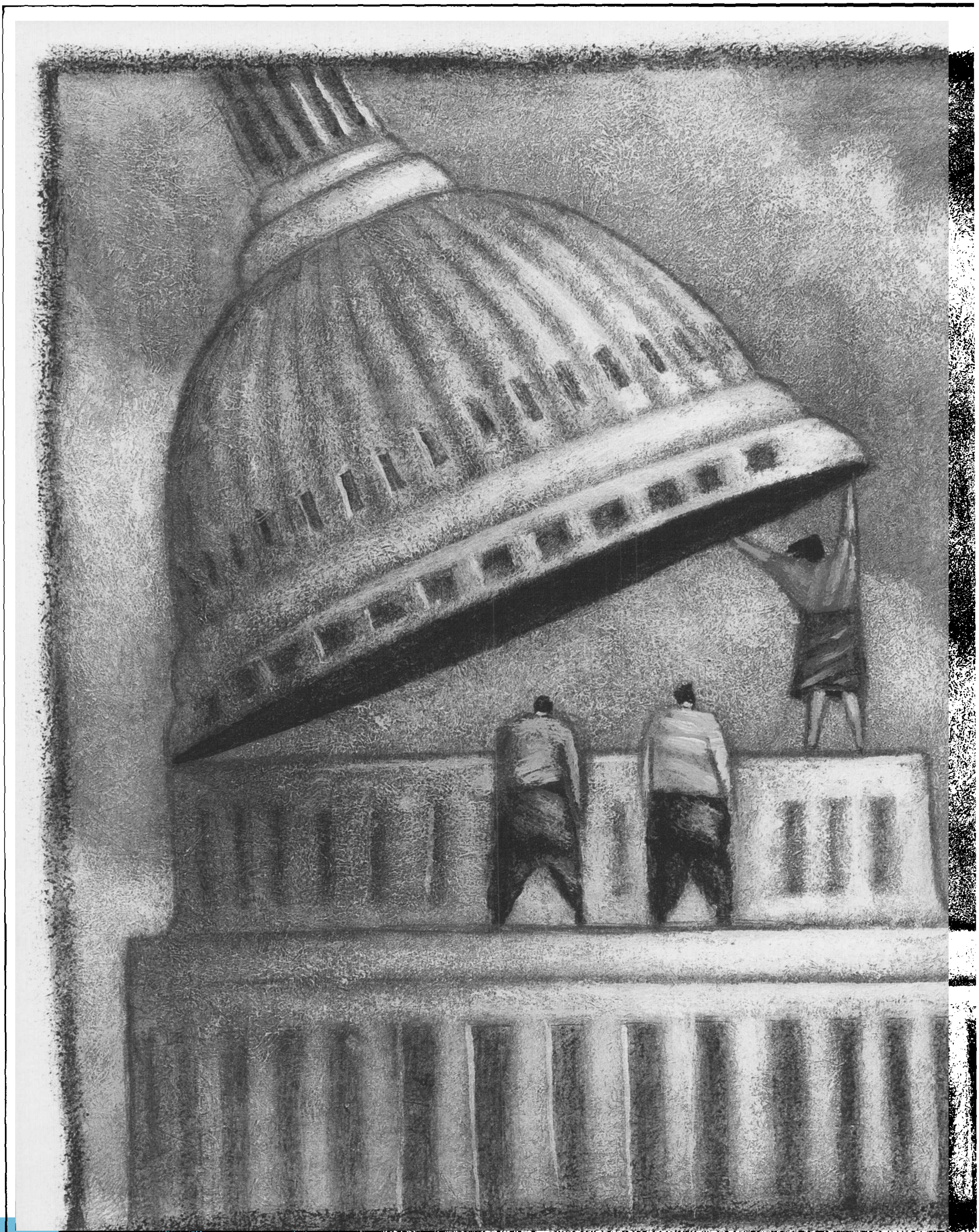

First Audited Governmentwide

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The federal government recently issued its first-ever audited financial statements. Considering the feds already require that type of accountability from both state and local governments and publicly owned companies, one might wonder whether this is a noteworthy event. The answer is yes—it has been a fascinating process and a monumental effort requiring years of planning and preparation and the efforts of thousands. Governmental managers, accountants and auditors are likely to have significant interest in what these statements disclose and do not disclose, not to mention the manner in which they were prepared and audited. Policy officials and others interested in the programs and activities of the federal government will find these financial statements provide a perspective for assessing the federal financial condition that was not previously available.

Background

"A regular Statement of Account of the Receipts and Expenditures of all public Money shall be published from time to time," states Article I, Section 9 of the U. S. Constitution. The Department of the Treasury has fulfilled this requirement by annually preparing a report on the federal government's receipts and outlays. The report "The United States Government Annual Report and Appendix," satisfies the letter of the law. Unfortunately, the report presents only the budget results (cash taken in and cash paid out) and the cash-related assets and liabilities of the federal government. The report does not include information on other government assets, such as property, plant and equipment or accounts and loans receivable. Nor does it include information on such substantial government liabilities as federal employee and veterans' benefits payable and liabilities associated with environmental clean-up.

The only attempt to fill this gap has been a prototype consolidated financial statement, published annually since 1976. This statement presented information about the various assets and liabilities of the government. However, the information was obtained in a manner that precluded it from being complete or accurate. Nor did the presentation reflect the federal government's unique characteristics.

In 1990, the government enacted the Chief Financial Officers Act to "bring more effective...financial management practices to the federal government...." and to "provide for the issuance of reliable financial information...." One of the most significant elements of the act was a requirement for the preparation and audit of organizationwide financial statements by selected departments and agencies.

At the same time, the Office of Management and Budget (OMB), the Department of the Treasury and the General Accounting Office (GAO) established the Federal Accounting Standards Advisory Board (FASAB). The board's function was to consider and recommend accounting standards tailored to the federal government's unique characteristics and special needs. By the end of 1996, FASAB completed work on the basic set of federal financial accounting standards. The completion of these standards meant that for the first time in its history, the federal government, the largest entity in the world, had a comprehensive set of accounting standards with which to measure and present its financial position and results.

These two changes contributed to significant improvements in the reliability and usefulness for decision-making of the financial information issued by federal agencies. Thus in 1994, Congress extended the requirement for organizationwide audited financial statements to all of the 24 departments and largest agencies in their entirety. It also specified that starting in fiscal year 1997, financial statements for the entire federal government would be prepared and audited.

While Congress was expanding the audited financial statement requirements of the CFO Act, the National Performance Review (NPR) was also concluding that the public expected greater accountability from its government. NPR recommended that the government establish 1997 as a goal for audited governmentwide financial statements.

Governmentwide

The purpose of the governmentwide financial statements is to demonstrate the federal government's accountability by providing the president, Congress and the American people with reliable information about the financial position of the United States government, the cost of its operations and the funding sources used to support these operations. A secondary purpose is to subject the United States 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.

There are, however, certain limitations with the financial statements. Some, concerning reliability of the data, were cited by GAO in its audit report accompanying the statements.[1] Another is that they cannot be used to monitor and control the use of budget appropriations. Also, they do not include values for significant assets and other resources, the most important of which are the government's power as a sovereign entity to obtain revenues through taxation subject to the political process; natural resources, since the FASAB has not yet recommended criteria for measuring and reporting them; and values for stewardship lands (national parks, forests and grazing lands) and the assets that comprise our national heritage, such as national monuments, museums and library collections.

Finally, since the government is a sovereign entity, many of the reported liabilities can be abrogated by an act of Congress and most cannot be paid unless legislation is enacted to provide the resources.

Consolidated

The governmentwide financial statements cover the executive branch, as well as parts of the legislative and judicial branches. The information for the legislative and judicial branches is limited because these entities are not required to prepare comprehensive financial statements. For example, the property plant and equipment of the judicial branch and Congress are not included in the financial statements. Moreover, the government- sponsored enterprises (GSEs), such as the Federal National Mortgage Association or the Federal Home Loan Banks, are privately owned and therefore not included. The Federal Reserve System is not included because organizations and functions pertaining to monetary policy are separate from and independent of the other central government organizations and functions.

The governmentwide financial statements were prepared and presented using the accrual basis of accounting—the transactions are reported based on when the events giving rise to the transactions occurred. This differs from the budgetary or cash basis, under which transactions are reported when cash was received or paid.

A quick reading of the government-wide financial statements shows that the net cost of the government's operations was $1,603 billion for fiscal year 1997. Net cost represents the difference between the full costs of government operations ($1,761 billion) less revenue earned by providing goods and services to the public ($158 billion). The largest component of net cost was human resources at $933 billion. These are the costs for education and training, health care, social security, income security and veterans' benefits and services. The other significant components of net cost included interest cost of $246 billion and national defense costs of $234 billion.

Taxes and other revenue generated by the government as a result of its sovereign powers (nonexchange revenues) are the primary resources used to finance the federal government's net cost of operations. These nonexchange revenues totaled $1,577 billion. The largest component of nonexchange revenues was federal income, social security and Medicare taxes paid and withheld. The aggregate of these taxes was $1,248 billion.

As of September 30, 1997, the United States government reported assets of $1,602 billion, the most significant of which was property, plant and equipment of $1,017 billion. The major component of property, plant and equipment was military equipment valued at $636 billion. FASAB is proposing that, beginning with the 1998 financial statements, values associated with military equipment be removed from the balance sheet and that information about these assets be reported in the stewardship section of the financial statements.

The other major assets reported in the financial statements include

- Cash of $93 billion, which included gold valued at $11 billion and international monetary assets of $36 billion.
- Loans receivable, or rather the net present value of the loans likely to be collected, of $156 billion. The gross amount of these receivables was $217 billion.
- Inventories of $209 billion, which included not just materials and supplies and items held for resale valued at $164 billion, but also many materials that reflect the federal government's unique role and authorities. Examples of the latter are stockpiles of critical materials, seized and forfeited assets and even commodities held under farm price support and stabilization programs.

At the end of fiscal year 1997, the United States government reported liabilities of $6,605 billion. The largest component of these liabilities was represented by federal debt securities held by the public ($3,768 billion). These liabilities do not include $1,620 billion of federal debt securities held by federal trust funds. Securities held by federal trust funds were eliminated in the consolidation process.

Other major liabilities reported in the financial statements included

- Pension, disability, health care and other retirement liabilities for veterans and retired military and federal employees, estimated at $2,244 billion. These liabilities were split between civilian employee benefits of $1,165 billion and military employee benefits of $1,079 billion.
- Environmental liabilities, estimated at $212 billion. This amount is likely to increase significantly. The agencies are just beginning to identify and estimate the probable cost to clean up environmental contamination on federal lands. There is also considerable uncertainty inherent in the estimates of the cost to clean up these contaminated lands.

The United States government's financial statements also report the substantial future commitments the government has to its citizens. These amounts include commitments associated with social insurance programs such as Social Security and Medicare. The complex characteristics of social insurance programs and the fact they blend elements of exchange and nonexchange transactions are among the reasons cited for not including these future commitments as liabilities on the balance sheet. Although the amounts are not reported on the balance sheet, the future commitments are discussed in the stewardship responsibility section of the financial statements. Other commitments are disclosed in the commitments and contingencies footnote to the financial statements.

Specifically, the financial statements report that the Board of Trustees of the Federal Old Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Funds estimate that the combined expenditures of these two trust funds will exceed current tax revenue beginning in 2012. The trustees also estimate that by 2029, the trust fund assets, which are made up of investments in federal securities, will be totally exhausted. This information highlights the need for policy-makers to address the long term financing needs of the program.

Information included in the financial statements about the Medicare Part A Hospital Insurance Trust Fund (HI) presents a similar picture. The assets of the HI Trust Fund, which are also made up of investments in federal securities, are expected to be totally exhausted in 2010. Trustees of the HI Trust Fund estimate that, by 2022, the present value of actuarial expenditures of the HI Trust Fund will exceed the present value of actuarial contributions by $1,845 billion.

The other commitments and contingencies disclosed in the footnotes to the financial statements included

- Commitments associated with the programs to insure such things as the safety of bank deposits or the risk of flood or crop losses, totaling $2,774 billion. These amounts represent the most conservative possible assumptions of maximum risk exposure. They are not future claims on federal resources.
- Guarantees against default of $712 billion worth of housing, agriculture, education or other loans. Although this is the maximum risk exposure and thus not likely to be claimed in full, the risk of having to pay a major portion of the guarantees is still substantial.

The ramifications from this first presentation of governmentwide financial information fall into two categories: those pertaining to the reliability of the information and those pertaining to the significance of the information. In the first category is the realization that the government has little or no data to support many of the reported assets. Nor is there any certainty that the amounts of reported liabilities are complete. The agencies have not been required to maintain this type of information. Hence, although they established and operate systems to monitor the execution of budget appropriations, they devoted little attention or resources to systems that could record assets, liabilities and costs.

Moreover, the agencies cannot reconcile their accounts with each other and the financial statements in their entirety contain an unreconciled "plug" of $12 billion. This is the result of such practices as agencies not informing other agencies of transactions that affect the latters' accounts, agencies recording the same transactions in different time periods and agencies changing their account balances without informing the Department of the Treasury. Finally, other weaknesses in controls have impaired the accuracy of the reported costs, particularly those for defense and health care.

The first ramification pertaining to the significance of the information is that, in and of itself, the process of having to gather the data is forcing the government to identify and research the full magnitude of its liabilities and other commitments. Second, the liabilities for civilian and military employee benefits, and the future commitments associated with the Social Security and Medicare programs contribute to the evidence that we are about to witness the most significant intergenerational transfer of resources this country has ever experienced. The governmentwide financial statements are the only document produced by the federal government that include the information needed to assess the extent of this potential intergenerational transfer. It is clearly evident that both the process and the presentation is providing considerable information for future policy-makers to consider and is providing American citizens with more comprehensive information about the operations of their government.

Unique Issues

The governmentwide financial statements were developed not by consolidating the individual agencies' financial statements, as one might consider. The following process was used instead.

- The agencies forwarded electronically to Treasury, via a system called FACTS (Federal Agencies' Centralized Trial-Balance System), the balances in their general ledger accounts. Since the agencies maintain separate trial balances for each appropriation account, the balances were at the appropriation account level.
- Treasury aggregated the appropriation account level trial balances received from each agency into an agency level trial balance which Treasury transmitted back to the agency.
- Each agency compared the trial balance aggregated by Treasury to its agencywide financial statements. Several agencies were unable to provide assurance that amounts submitted to Treasury agreed with their agency financial statements. The GAO identified problems associated with the process of compiling the financial statements as one of the factors contributing to the unreliability of the amounts reported in the financial statements.

Treasury's sending the agency trial balances back to the agencies for review (and approval) could be considered an extra step that some thought could have been eliminated simply by having the agencies do the aggregating. However, Treasury knew that the Statement of Net Cost would need to present expenditures by function; the trial balances for many agencies would not show the functions for which expenditures are made, but the individual accounts would. Also, Treasury needed the information for many agencies that are not required to and did not prepare agency financial statements. Examples are the Securities and Exchange Commission and the Federal Communications Commission.

Several unique issues arose during the preparation of the governmentwide financial statements. The following were the most noteworthy.

- The legislative and judicial branches do not prepare agencywide financial statements and therefore provided only budgetary data. Considering that salaries and benefits are their major expense, this did not cause a major problem for reporting operations. However, it does mean that values for the two branches' capital assets, such as the U.S. Capitol and the extensive number of court buildings, are not reported in the governmentwide financial statements.

- The FACTS data submitted by agencies not covered by the CFO Act was often incomplete, in that it did not contain information pertaining to assets and liabilities. Fortunately these were the smaller agencies and the amounts were immaterial.
- As indicated, the agencies have considerable transactions with each other. For example, agencies rent and pay for space from the General Services Administration; they forward employee retirement contributions to the Office of Personnel Management. Unfortunately, agencies do not always recognize and record these transactions as intragovernmental transactions. Moreover, while the standard general ledger requires that the agencies code transactions as intragovernmental (or with the public), the codes do not identify which agencies the transactions are with. The inability to reconcile intragovernmental transactions contributed to the $12 billion identified on the statement of changes in net position as "unreconciled transactions." The $12 billion was the net of more than $100 billion of unreconciled transactions, both positive and negative amounts.
- The budget deficit is the best known representation of how the government performs financially during the year. The governmentwide financial statements, however, report a number for the change in net position that appears to have the same meaning as the deficit but is markedly different in amount. Thus the governmentwide financial statements would benefit from a reconciliation of the two numbers. However, the information needed to reconcile the reported change in net position of $3 billion and the reported budget deficit of $22 billion was not available. Once the federal government produces reliable consolidated financial statements, an effective reconciliation would provide additional assurance of the reliability of reported budget results.

Governmentwide

The process for auditing the governmentwide statements was equally innovative. It built on the audits of the financial statements—performed by inspectors general, certified public accounting firms and the General Accounting Office—of the 24 departments and agencies covered by the Chief Financial Officers Act as well as the audits of significant other large entities such as the Federal Deposit Insurance Corporation.

GAO, as the principal auditor, worked closely with the IGs and certified public accounting firms. At many of these agencies, GAO performed audit procedures on accounts that were material to the government's consolidated financial statements. In addition, GAO conducted audits of separate agency components and performed audit procedures on certain critical governmentwide activities. For instance:

- GAO rendered an unqualified opinion on IRS's custodial financial statements, which covered the $1.6 trillion tax revenue collected by IRS.
- GAO expressed an unqualified opinion on the Schedule of Public Debt prepared by Treasury's Bureau of Public Debt, which included the $3.8 trillion of federal debt held by the public and the related $246 billion of interest on that debt.
- Audit procedures were performed by GAO on the cash balances maintained and internal controls over cash receipts and disbursements processed by Treasury on behalf of the federal government.

GAO also planned to rely on the agencies' assurances that the data submitted via FACTS were the same data the agencies' auditors examined for the agencies' audited financial statements. However, several agencies were unable to provide assurance that the data were the same.

No other entity in the world is comparable in size and scope to the United States government. As one might expect, an audit of an entity this large and complex would have a number of unique audit issues not normally found in audits of financial statements. Some of the major issues were as follows:

- Audit standards require that in an audit, the auditor obtain written representations from management about matters that are individually or collectively material to the financial statements. The representations should be addressed to the auditor and signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about matters covered in the representations. Normally these are the chief executive officer and the chief financial officer. However, the federal government is so vast that its CEO, namely the president, could not be expected to have this knowledge. After a great deal of debate and negotiation, the solution was to prepare a representation letter that addressed the unique circumstances of the federal government and include a qualification that the representations are based on the knowledge of the individual agencies' CEOs and CFOs.

  It was also difficult agreeing on who should sign the letter—perhaps as difficult as agreeing on its content. This issue was resolved by having the letter signed by OMB's deputy director for management, who is the federal government's chief financial officer, and by the Department of Treasury's under secretary for domestic finance, whose organization was responsible for compiling the financial statements.
- A similar but less significant problem arose with the legal representation letter—namely what should it contain and who should sign it? The solution was similar; include a qualification in a letter to be signed by the assistant attorney general for administration that the representations were based on the representations of the individual agencies' general counsels.
- The timing of the audits of the agency financial statements could also have been a major audit issue. Many of the agencies are having difficulty getting their audits completed by the statutory date of March 1. If information included in an agency's financial statement is material to the governmentwide statements and the audit work on that information is not completed in a timely manner, the audit report on the governmentwide statements could be adversely affected. This situation occurred this year. Nine agencies did not issue their audited financial statements by March 31, the date the governmentwide statements were issued. However, the situation did not create a problem because auditor's of the Department of Defense's (DoD) financial statements issued a disclaimer of opinion on DoD's statements by March 1. Since DoD is so material to the governmentwide financial statements, delays in other agency audits had no impact on the opinion on the governmentwide financial statements. Solving this problem will require agencies to accelerate the process for preparing and auditing their financial statements so that they meet the statutory deadline. If agencies are still unable to meet the statutory date, they will have to disclose to GAO those matters for which it appears their audit will not be completed on time. GAO will have to decide about the materiality of the matters, and, if necessary, accelerate the audit process for those matters.

Audit

The benefits of this first audit extend beyond having a financial perspective not previously available. The primary benefit is the exposure of the many tasks that still need to be accomplished in order to have complete and correct financial information. For example, it will be necessary to update the Standard General Ledger in order to have information available to account for the agencies' financial dealings with each other or to reconcile the results of operations with the budget deficit.

A recognition of the need to update the Standard General Ledger has also been demonstrated by the agencies' inconsistent reporting of similar transactions. The Standard General Ledger was designed to provide a framework for rational and consistent recognition of transactions by the federal agencies, not as the foundation for governmentwide financial statements.

Another realization is that the judicial and legislative branches should be maintaining data they heretofore have not kept about their capital assets. This is not a constitutional matter; it is an issue of good management. Also, agencies with responsibility for cleaning up the environment have to identify the hazards and estimate the cost for clean-up. But even here there is the question of who is responsible. Should the Department of Defense or the Department of the Interior have to remove the contamination caused by the former's explosion of bombs on the latter's land?

And finally, there are issues associated with information not yet provided because the standards do not require the data or the data are not available. Examples are the information needed to disclose such things as the investments in human capital and research and development, the future costs to continue providing services and, most important, the levels of performance for these services.

CONCLUSION

Considerable effort is under way across government to make needed financial management improvements, and progress is being made. However, it will take concerted sustained attention by senior officials to rectify years of inattention. GAO's Assistant Comptroller General, Gene L. Dodaro, CGFM, described the situation in his testimony before the Subcommittee on Government Management Information and Technology. He stated that "significant financial system weaknesses, problems with fundamental record keeping, 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.*" (emphasis added)

The effort to put the federal government on the same level of fiscal accountability demanded of the private sector and state and local governments is no small task. Audited financial statements provide a framework in which to evaluate the government's management of tax dollars. As usually occurs in a first year audit, numerous problems were identified and the federal government did not get a clean opinion on its financial statements. But perhaps more than any other process, an annual financial audit provides a stimulus for the systematic identification and correction of deficiencies. The result, which the president has committed to for fiscal year 1999, can be accurate and reliable financial information that an unqualified auditor's opinion signifies.

End Note

1. The statements, with accompanying text and the auditor's report, are available from the U.S. Department of the Treasury's Financial Management Service website at *www.fms.treas.gov* or by calling the Government Printing Office at 202.512.1800, product number ISBN 0-16-042737-1.