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Task Force on Federal Budgeting and Financial Management

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FINANCIAL MANAGEMENT IN THE FEDERAL GOVERNMENT: A SYSTEM IN CRISIS AND OPTIONS FOR REFORM

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The United States Federal Government controls and directs cash resources in excess of \$1 trillion dollars each year. Yet, at a time when Congress must make important decisions on future budget priorities and commitments, the information necessary to make such important policy decisions simply does not exist. Weak government-wide accounting and financial management systems have resulted in a situation where there is little reliable information on how the government currently spends its money and on how decisions that are made by today's leaders will affect tomorrow's generations.

Simply put, the systems we currently depend upon are fragmented, incompatible, antiquated and unreliable. The compilation of financial data takes an inordinate amount of time and often the information is provided too late or is too incomplete to be of any use for informed decision making. Investment expenditures and current operating expenses are both treated equally, even though they have very different immediate and long-term implications. The result is that Federal financial management systems are a pervasive source of government waste.

At the same time, it is important to recognize that fiscal irresponsibility and lack of public accountability have no party allegiance, political agenda or parochial support. Instead, they are the inevitable outgrowth of inherently weak budget, accounting and financial management systems. Any attempt to correct our nation's current fiscal ills cannot be successful unless these fundamental systemic and structural deficiencies are addressed fully. The purpose of this Task Force effort is to make the case for needed changes and outline an effective set of bipartisan reforms leading to truth in government budgeting, accounting and spending.

The Current Challenge

When looking at the Federal Government's current financial management practices, several areas of deficiency are readily noticeable.

o ACCOUNTING AND REPORTING SYSTEMS

For years, the General Accounting Office's (GAO) famous blue-covered reports have been telling us the same story: our departments and agencies are a veritable jungle of special purpose, incompatible, antiquated accounting systems producing unreliable, and often irrelevant financial information. In fact, one GAO study reported that more than half of all agency accounting systems do not conform even to GAO accounting principles, standards and related requirements.

Similar conclusions were reached in a September 1985 study conducted by the Systems Committee of the President's Council on

Management Improvement entitled "Strategic Plan for Federal Financial Management." Its results come directly from those on the firing line: financial management executives in Federal departments and agencies. Those interviewed regarded less than 50% of governmental accounting and financial reporting systems as capable of producing timely, accurate and relevant information for management decision making. Sixty-one percent of the systems cannot provide the data necessary for assessing management performance; 35% of the systems were considered incapable of providing sufficient data to support the allocation of funds; and 33% do not provide effective control over and accountability for assets.

The extent to which the government as a whole departs from basic accounting textbook requirements -- to say nothing of common sense -- defies logic. An earlier GAO study, "Managing the Cost of Government," pointed out, for example, that agency budgeting and accounting for program costs are largely done on different bases, and are isolated from one another. Budgets are requested and justified in terms of programs and projects, such as infant health care or dams for flood control. Yet, accounting and other financial reports often focus on appropriations and categories of expenses such as travel or personnel, without relating them to the particular programs or projects for which the money was requested and approved.

The resulting waste from these abuses runs into the billions of dollars. For example, in its latest annual report to Congress, GAO cited the Department of Defense's failure to account for over \$600 million in advances made by foreign customers for weapons systems purchases. In addition, the report also noted that the Federal government loses at least \$350 million annually because agencies either paid their bills too late and incurred interest penalties, or they paid them too early and forfeited potential interest income.

o FINANCIAL MANAGEMENT

Currently, Federal financial management responsibilities and functions are seriously fragmented with continued overlap and duplication. Financial management functions are split among several agencies in the executive branch including the Office of Management and Budget (OMB), the General Services Administration (GSA) and the Department of the Treasury. In addition, each of the various executive branch agencies, and the GAO in the legislative branch, have their own systems and guidelines for financial management.

The greatest problem with this approach is that no single agency or individual has clear responsibility for oversight and direction of the Federal government's financial management operations and activities. Furthermore, financial management responsibilities have frequently been shifted from one central

agency to another; and in each central agency, financial management functions have competed with a number of other responsibilities for their fair share of attention.

In the case of faulty internal control evaluations and faulty accounting system compliance assessments, the GAO has cited OMB's failure to develop adequate guidelines as a principal cause. Yet, the development of such guidelines may require more time, resources and expertise than OMB can provide, or is likely to provide under the current system. OMB's lack of resources and the secondary role of financial management to budgetary considerations hamper OMB's ability to give adequate emphasis to financial management matters.

While OMB, of late, is giving financial management the increased attention it deserves through Reform 88, a Reagan Administration initiative to improve government management and reduce waste, fraud and abuse, it is a highly specialized area which deserves independent, continued attention from administration to administration. Unfortunately, it does not now have that status. When the Reagan Administration leaves office, there is no guarantee that this reform will be continued by the next administration.

o THE CASH-BASIS SYSTEM TO MEASURE SPENDING

When it comes to defining what is government "spending," the Federal Government is light years behind the private sector. The Federal Government currently uses cash-basis budgeting and accounting systems to measure government spending. This system is nothing more than a simplistic measure of how much an entity takes in and how much it spends and is very similar to the way a household checkbook is managed.

In simple terms, imagine planning a family's financial future by only looking at checkbook balances and ignoring other assets as well as current and future liabilities. For one thing, this method ignores the equity being built up in a home, as well as the future costs of sending children to college. While providing important information about cash flow and the ability to pay bills on time, a checkbook tells you little about the financial ability to address current costs and future needs. A \$500 expense for a vacation would be treated no differently than a \$500 outlay to purchase a savings bond, although each has a profound and uniquely different effect on a person's financial condition.

The most important decisions being made today by the Federal Government are based upon their effect on today's government checkbook balance. Little consideration is given to the qualitative nature of these expenditures and even less attention is given to future costs and liabilities. There is virtually no distinction between the government purchasing an asset with

future public benefit, or government simply making a transfer payment from one segment of society to another for current consumption. As a result, Congress and the President constantly fight over meeting short-term budget goals and targets without any regard to the long-term implications of their decisions on the economic health of our nation.

o OBSCURING FISCAL REALITIES

Reliable and consistent financial information on government spending is scarce, but even when it does exist most Members of Congress are often not made aware of it. Furthermore, even when it is available, current financial data on government programs and related spending are not available in a comprehensive or understandable format that can be utilized by Congress to make the right decisions at the right time.

Another serious problem exists with the use of a unified budget and the mixing of budget accounts. Under the current system, trust fund accounts which are in surplus are added to the unified budget to offset deficits in other areas of the budget. The problem with this is that, by law, the surpluses in those trust funds can not be used to pay for spending in non-trust fund accounts. Yet, on paper, and through the purchase of Treasury bills, these surpluses are used to offset non-trust fund deficits.

There are important implications resulting from this practice. First, while the public is told that certain taxes and fees will be used to pay for specific programs, these revenues are being used to purchase Treasury notes and fund other programs that the public may be less willing to support. One example is the Airport and Airway Trust Fund, which is the primary source of funding for airport improvement and air safety programs. Financed through airline ticket taxes and other airports and airline user fees, this fund has close to \$5 billion of fees and taxes raised for air safety improvements that have gone unappropriated for this purpose. Instead, they have been used to offset the total budget deficit by adding them to general revenues.

This mixing of funds highlights a second important implication. By borrowing from specific trust funds to pay for other government operating expenses, Congress has been able to disguise the scope and size of the budget deficit. For instance, in Fiscal Year 1987, a \$19.5 billion surplus in Social Security Trust Funds was used to offset the budget deficit by that same amount, making the deficit look much smaller and helping Congress to meet its budget targets. While there may be immediate benefits from using these surplus funds for this purpose, in reality this practice masks a more serious imbalance between spending and revenues in other parts of our budget.

Present and Future Implications of Federal Financial Management Practices

In addition to the obvious result of pervasive waste due to poor financial management, current weaknesses present other significant problems.

1) The Federal Government Has Trillions of Dollars of Unrecorded Liabilities With No Provision to Pay for Them

The Federal Government has made a number of commitments and promises to pay future benefits without adequately planning on how it intends to pay them. These unrecorded and unfunded liabilities include Federal pension programs, loan guarantees and insurance funds. For example, despite collecting premiums from our nations savings and loans institutions to fund the "self financing" Federal Savings and Loan Insurance Corporation (FSLIC), last year Congress needed to pass a \$10.8 billion bailout of the FSLIC to prevent it from becoming insolvent. Furthermore, many banking experts believe that many billions of dollars more will be needed to insure possible future financial exposure.

Due to the current cash-basis accounting system of the Federal government, no provision is being made for these very real liabilities. The discrepancy between the reported national debt on the cash-basis method versus accounting methods that measure these liabilities is staggering. As of fiscal year 1987, the reported cash-basis national debt was \$2.35 trillion. In contrast, the national debt is estimated to be in excess \$4 trillion using methods that account for our liabilities as well.

Another troublesome area is the Farm Credit System, which has lost \$5 billion since 1985. Yet in 1986, it was allowed to defer losses for up to 20 years. Currently, financial exposure for the Federal government in this program is estimated to be between \$3 billion and \$10 billion, none of which is required to be accounted for in today's Federal budget.

2) Current Liabilities Tie the Hands of Future Leaders

One of the most important cornerstones of sound government is the ability to provide flexible responses to new problems and challenges that a nation faces. Unfortunately, by failing to account today for our commitments, we are significantly reducing the flexibility of future leaders to respond to new and unforeseen situations. New challenges could require oppressive new taxes or dramatic cuts in essential government services. These future constraints may not be too far off either. What happens if the FSLIC system requires a new infusion of \$15 billion? No provision has been made for such an emergency, so billions of dollars could be added to the deficit and unexpected

reductions may be necessary in other Federal programs.

3) Poor Information Results in Poor Decision Making

With budget formulation systems that do not relate to each other or to the actual implementation and expenditure reporting process in the Federal government, Congress can give little focus to accurately monitoring and comparing agency budget requests to actual expenditures. Budgeting is done on an obligation basis while the execution process is recorded with an accounting system that utilizes a combination of obligation, cash and accrual bases. Furthermore, the Federal Government lacks a government-wide system to measure and evaluate program performance. The result is inconsistent data with decreased usefulness as a management tool in sound budget preparation or monitoring.

An example of poor planning caused by such inadequate reporting is the manner which office space is provided for government agencies. Currently, if an agency is in a government-leased building, only the current year's rent is reflected in the current budget as an expense. Conversely, if the agency constructs a building, which would be more economical in the long term, the entire construction cost would be recorded as an expense in the first year. As a result, the Executive agencies and departments have become more reluctant to build or buy a building because this would increase the current deficit even though a decision to build or buy may be less costly over the long term.

Moreover, with poor information and a reliance on simplistic cash-basis data, Congress's ability to act as a serious oversight body for the programs it enacts is greatly diminished, if not completely undercut. Congress depends on executive agencies to provide accurate, timely, reliable and complete financial disclosure of their program activities. When it fails to receive such reporting from the agencies, Congress can not make good decisions.

Options for Change

As the discussion above demonstrates, there is no one magical panacea that will solve the problems that exist in the financial management of the Federal Government. Indeed, reform must be comprehensive, not piecemeal. Capital budgeting, to take but one example, only makes sense when used in accordance with generally accepted accounting principles.

1) Adoption of Generally Accepted Accounting Principles (GAAP).

Generally Accepted Accounting Principles (GAAP) have been developed over the course of accounting history to assist

managers in accurately portraying financial transactions and allow the users of financial documents to understand the basis on which they were prepared. They are defined by the Financial Accounting Standards Board (FASB) of the American Institute of Certified Public Accountants, an independent professional group sanctioned by the Securities Exchange Commission (SEC) and highly regarded by the public. In addition, the Government Accounting Standards Board (GASB) was formed as an offshoot to FASB in the early 1980's to formalize accounting standards for government.

While the use of GAAP may seem obvious to many accountants, the Federal government does not employ it. Using GAAP for the Federal Government has many advantages because it recognizes liabilities as they are incurred and associates the cost of assets with the period during which they are utilized or consumed. By painting a more complete and accurate picture of government finance, Federal decision makers would have access to much better information than currently provided by the cash-basis "snapshot."

To take one example, pension liabilities, which today are budgeted in the same way as welfare payments-- that is, pay as you go -- would instead be recorded during the period in which employees worked and assets would be depreciated over the course of their useful life. Government programs utilizing assets acquired in previous periods would reflect the current allocable cost of those assets as well as current operating expenditures associated with such programs.

Opponents of GAAP for the Federal Government contend that its additional workload and reporting requirements are major obstacles to its implementation. However, while the process of implementing GAAP could not be accomplished overnight, the production of accurate comprehensive financial data is a mandatory prerequisite towards eliminating waste, achieving high levels of efficiency and cutting costs. Furthermore, GAAP is not a new idea to the Congress. In order to help prevent fraud, the Federal Government requires all publicly traded corporations to use GAAP before they are allowed to sell one share of stock. In addition, Congress required New York City to adopt GAAP as a condition for its Federal bailout in the mid-1970s.

2) Uniform Government-wide Accounting and Reporting Procedures.

In order to be able to produce meaningful consolidated reports, it is essential that the various agency accounting systems be compatible enough to produce information which can be consolidated without combining apples and oranges. Similarly, agencies must have standard procedures with which to work,

otherwise information produced by their accounting systems will not be comparable. If, for example, one agency lists salaries as a program expense while another lists them as an administrative expense, it will be difficult to determine from their financial reports which is operating more efficiently. It will also be impossible to consolidate their reports into a single statement of overhead costs that can provide meaningful qualitative as well as quantitative information.

Currently, the Treasury, GAO and OMB are attempting to establish uniform accounting and reporting systems using the Joint Financial Management Improvement Program to coordinate their efforts. The standard general ledger developed by the Treasury and standards promulgated by OMB should result in increased standardization of financial reporting. But, the GAO, as a legislative agency, lacks authority to issue regulations directly affecting executive branch activity. Federal financial managers should be required to implement the standard general ledger and meet required standards or face possible loss of merit pay and/or replacement.

3) Implementation of Uniform Government-wide Audit Standards.

Any accounting system is only as good as the auditing standards which ensures its reliability. Federal financial systems should be audited regularly and agency financial statements should be audited prior to being made public. Audit standards must be consistent for all agencies and designed to determine the level of an agency's compliance with uniform government accounting practices.

In order to provide useful information on the efficiency of government operations, audit standards should contain clearly defined performance measures for each agency. The product or service each agency is expected to provide should be clearly stated. Costs associated with production of each government product or service should be identified. Good audit standards should allow government leaders to examine the "cost per unit of product" for each agency. Such information should be produced for each of the 1200 appropriation accounts and included as an appendix to the annual budget report.

To examine the "cost per unit of product or service" for the various agencies, Congress will have to give serious thought to the purpose and mission of each agency and define the "product" they are expected to produce. For example, in evaluating social services agencies, should decisionmakers measure the amount of services provided such as the number of meals served to the hungry, the number of persons placed in homeless housing or the number of people taken off of public welfare rolls? Or should program performance be determined by other factors, such as a percentage reduction in a problem that an agency was directed to address.

The Federal Government is not like an auto factory, so clearly some of the services provided by government agencies are not easily quantifiable; however, at the very least, a "product" should be defined and the costs of producing it should also be identified. Improved audit standards will enhance Congressional oversight since they will clarify the products or services government provides and identify the costs associated with producing them. More efficient means of producing government goods and services may be identified and priorities will be easier to establish.

4) Adopting a Capital Budget.

Capital budgeting is a process or financial system (including budgeting, accounting and auditing procedures) used to control long-term "capital" investments both physical and financial. Capital budgeting processes involve:

- Projecting the activities of government over a given time period and determining the assets needed to support those activities;
- Choosing those assets whose useful life would extend throughout the time period or at least beyond the duration of the operating budget;
- Determining a financing method and amortization schedule to be used to allocate costs equitably throughout the useful life of the capital asset;
- Determining the portion of the operating budget which could be allocated to debt service or depreciation;
- Determining, based on current markets, the amount of financing available for the portion of the operating budget which can be allocated to debt service (e.g., if the government has revenues of \$1000 and can allocate 10% (\$100) to debt service, then a market which requires repayment of 5% of the loan each year and payment of 5% interest would allow borrowing of approximately \$2000 over a 20-year period);
- Determining, in priority order, which assets can be acquired given available credit;
- Adjusting either capital acquisition plans or operating revenues as indicated; and
- Issuing debt instruments, acquiring assets, and monitoring the capital investment plan and modifying as needed.

Opponents of capital budgeting are concerned that this system will be used to generate increased Federal spending; however, this is not the case. A capital budget does not mandate any new spending. Rather, it is an advanced budget reporting document that clarifies different types of expenditures and provides more comprehensive information on the nature of government spending.

Proponents of capital budgeting argue that it would promote generational equality, allow Congress to make more informed decisions, allocate funds more wisely, discourage short-term thinking and promote better long term planning. Capital budgeting also requires a differentiation between investments and operating expenses, and introduces the concept of depreciation into the budget, thereby focusing attention on replacement planning.

5) Centralized Financial Management.

As cited earlier, the financial management of the Federal Government resides largely in four agencies - the Treasury, the Office of Management and Budget, the General Services Administration and the General Accounting Office. The activities of these agencies are coordinated by the Joint Financial Management Improvement Program (JFMIP). Unfortunately, the Joint Improvement Program has neither the authority nor the resources to act as the central financial management agency for the entire government.

Centralized financial management is necessary to ensure compatibility of systems and enforcement of standards. Consolidation of financial management activities such as cash management, accounting, budget reconciliation and financial reporting would help streamline government operations and identify opportunities for the savings and/or increased return on investment. Additional responsibilities of a central financial management agency would include development of financial priorities, long-term financial planning and coordination of financial activity by the various agencies.

One reform that goes along with centralization of management functions is the creation of an independent Chief Financial Officer (CFO) of the United States. This individual could have authority to set and enforce Federal financial management and accounting standards as well as present financial plans and alternatives to Congress and the President. Enforcement mechanisms at the disposal of the CFO could range from refusal to certify agency financial statements to withholding of merit pay increases for Federal financial managers. Consideration should also be given to creating agency and department heads for financial management to ensure top-level, department-wide attention to the implementation of financial management

initiatives and activities at the agency level. These top managers could then work with the CFO to provide important avenues of communication and interchange between the central financial management function and its counterparts in the departments and agencies, resulting in more effective implementation and coordination of financial management initiatives.

6) Full Public Disclosure of Federal Spending and Financial Activity.

Improving the quality of financial information will not promote improved financial management unless the information is readily available to those who need it. Members of Congress, businesses considering investments, news media reporting on government spending and the general public concerned about how their tax dollars are being utilized all need and have a right to timely, relevant, accurate and easily understandable financial information about the Federal Government.

While a great deal of information exists about Federal financial activity, most of it is neither readily available nor easily understandable. Very few people outside the Treasury Department are aware that a standard general ledger even exists, let alone what sort of information is contained in it. OMB produces a very useful document called "Object Class Analysis Budget of the United States Government," which delineates government outlays and expenditures by categories such as personnel, travel and rent. However, this document is not listed in any directory and even many budget experts have never heard of it.

One method of providing widespread information about government finances might be to produce simple easily understood financial statements, similar to the annual reports issued by most corporations. In fact, the Social Security Administration has recently adopted this practice.

7) Improve Financial Education of Elected Officials.

Most elected Federal officials have a background in law, politics or state government. Very few have an extensive background in financial management. Yet, as discussed in this paper, the bulk of Federal decision making has a significant financial management component. Through a variety of activities such as seminars and lectures, Members of Congress and their key staff could learn more about the entire Federal budget, accounting and financial reporting process. Issues to be explored could include the Legislative and Executive budget processes, Federal financial management, and current government accounting and reporting systems. In addition, decision makers need to know how to access valuable budget and accounting information and how to use it when its made available.

CONCLUSION

While most people recognize that the Federal Government is not a private business and must respond to the demands of the American public, once policy decisions are made, the American people have a right to expect that their tax dollars will be properly managed and spent.

Sound financial management for the Federal Government is a good idea whose time is long overdue. Sound financial management is not just an accounting issue; it is not just a Republican or Democratic issue. Members of both parties can agree on the clear need for action in this vital area. If we do not build into the system a solid foundation of valid financial information, financial discipline and an effective organization, the entire structure is capable of collapsing right around us.

While each of the potential solutions for improving Federal financial management, fiscal responsibility and public accountability have merit in their own right, combined and enacted together, they would make a powerful step forward in improving integrity, credibility and truth in government.