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FINANCIAL MANAGEMENT REFORM IN THE FEDERAL GOVERNMENT

L. R. Jones
and
J. L. McCaffery

June 1992

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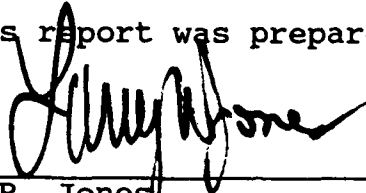
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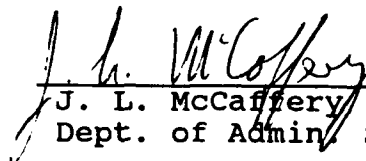
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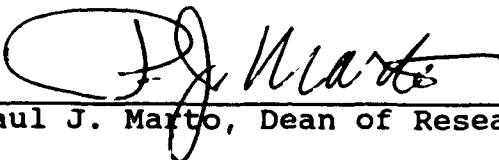
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FINANCIAL MANAGEMENT REFORM IN THE FEDERAL GOVERNMENT

Introduction

The decade of the 1980's was a fertile period for financial management reform in the federal government which culminated in the passage of the Chief Financial Officer Act of 1990.¹ While the Savings and Loan rescue had drawn attention to one set of federal financial management oversight mechanisms, other problems existed which, though less apparent, were very real: GAO and the Office of Management and Budget (OMB) studies of "high risk" programs in 1989 identified as many as 78 different problems which posed potential federal liabilities reaching into the hundreds of billions of dollars.² Other problems identified by Congress included failure of the IRS to collect \$63 billion in back taxes, an alleged \$30 billion in unnecessary inventories bought by the Department of Defense and losses at the Federal Housing Administration estimated at over \$4 billion. The identification of these problems helped muster support for the passage of the CFO Act and are the kinds of problems the Act is designed to help prevent.

The CFO Act is intended to knit the budget and accounting functions together and to centralize all financial management functions at the department and agency level with a chief financial officer reporting to the head of each agency or department. The centralizing bias of this act was further revealed in the official creation of a Chief Financial Officer for the federal government as

an Executive Deputy Director in the Office of Management and Budget whose task it is to take the lead on concept creation and development of system-wide efforts to improve federal financial management. Passage of the Budget Enforcement Act compromise in the Reconciliation Act of 1990 during the same time period tended to obscure the importance of the CFO Act, but now enough time has passed to allow for the full impact of this piece of legislation to be recognized. Its goal is to dramatically change the shape of federal financial management, relying, like the Budget and Accounting Act of 1921 before it, on financial management practices prominent and proven in the private sector. Among these are the requirement for one chief financial officer responsible for all financial functions reporting to the head of the agency, an annual financial statement that is understandable in generally accepted accounting terms and which will bear the weight of an annual audit and Inspector General certification, and a reduction in the number of separate department/agency accounting systems. The Act also has mechanisms for continuing modernization of financial systems. This study traces the development of financial management reform in the 1980's and summarizes some of the testimony that lead directly to the CFO legislation. The provisions of the CFO Act are described and a review is done of the issues and problems faced by those who must implement the act.

History of Federal Financial Management Reform

In 1948 the Joint Financial Management Improvement Program (JFMIP) was created to bring together the Director of the Bureau of the Budget (now the Office of Management and Budget), the Comptroller General of the U.S., the Secretary of the Treasury and the Director of the Office of Personnel Management to better coordinate disparate federal management functions. The JFMIP is credited with improving federal accounting, auditing, budgeting, financial management training and education,³ and cash management, e.g., establishing letter of credit financing. As a result of the JFMIP efforts, federal auditing standards were set, Offices of Inspector Generals were established in federal departments and agencies, and accounting standards were evaluated.

Several Hoover Commissions and the 1967 President's Commission on Budget Concepts led to the creation of the unified federal budget in 1968 and important changes in the role of the Office of Management and Budget. The President's Commission also pressed for improvements in federal receipts and outlay accounting and reporting. And, in 1974 perhaps the most significant single federal budget reform since the Budget and Accounting Act of 1921 was enacted in the form of the Congressional Budget and Impoundment Control Act, which reorganized the congressional budget process and established the Congressional Budget Office. However, other less visible efforts to improve federal financial management have been undertaken. For example, the General Accounting Office (GAO) and Office of Management and Budget have worked over the past two decades to improve and standardize federal accounting, auditing,

reporting, and other financial management procedures. Also, efforts to improve internal auditing in federal agencies initiated in the 1950's continue to the present.

The purpose for these and other efforts was summarized in 1981 by Elmer Staats, then the Comptroller General of the United States:

Good financial management can help retain this [public] confidence and trust . . . financial management is often very low on the list of priorities of many top governmental managers. Financial management deserves its fair share of their time and attention.⁴

In 1985, Charles Bowsher, the next Comptroller General, recommended a number of changes in federal financial management, suggesting that,

For too long 'financial management' in the federal government has been seen or at least practiced as a rather narrow function involving mainly accountants and budget analysts. Somehow, the idea of bringing management issues and analyses to bear upon budgeting and accounting questions. . . has not taken firm root throughout the [federal] government, in spite of some progress made in this direction over the last two decades.⁵

Bowsher also cited the need for a more comprehensive and consistent budget and budgetary accounting, better data on federal agency performance, improved planning for capital investment decision making, increased accountability for costs and results, and refined fund controls. Bowsher concluded, "Action along [these] . . . lines would provide the federal government with the tools needed for practicing pro-active financial management . . . this cannot be a short-term effort. Although policy makers should feel a sense of urgency about this . . . they have to realize that a full implementation would span several years."⁶

The development, passage, and implementation of the Chief Financial Officer Act in the federal government underscores Bowsheer's insight. The initial step in creating the CFO was made by the Executive branch. In July 1987, OMB director James C. Miller established administratively a Chief Financial Officer for the federal government in OMB.⁷ However, efforts to pass a federal financial management improvement act drafted in the House of Representatives (H.R. 449) during the 99th Congress to endorse Miller's action did not succeed. The chairman of the Senate Committee on Government Affairs also proposed in the same session a "Federal Management Reorganization and Cost Control Act" intended to ". . . correct the perceived void in financial management information, cash management and credit management practices."⁸ This legislation would have established an Office of Financial Management headed by a single Chief Financial Officer for the federal government, defined controller functions in federal departments and agencies, and created a Federal Financial Management Council. However, this legislation also was not passed. Neither was the bill (S.1529) sponsored by Senator John Glenn, chair of the Governmental Affairs Committee in the 100th Congress, titled the "Federal Financial Management Reform Act of 1987." Senator Glenn stated that his bill ". . . would finally make someone in the executive branch accountable for . . . a government-wide system . . . and financial management improvement plan . . ."⁹

Despite failure to pass CFO legislation, a number of advances were made in the 1980's in federal financial management including

increased compliance with selected provisions (Section 4) of the Federal Managers' Financial Integrity Act (FMFIA), creation of a schedule for adoption of standard general ledger accounting in federal agencies, consolidation of accounting systems, and adoption of uniform core requirements for federal financial systems (initiated by the JFMIP). However, the inability of Congress to pass enabling legislation hindered the effort to systematically improve federal government financial management. Additional attempts were made in Congress in 1988 and 1989 to develop support for comprehensive financial management reform legislation. However, it was not until mid-1990 that this law was enacted.

Recent Initiatives to Improve Federal Financial Management

The financial management activities of the federal government are awesome in scope. OMB and the Treasury Department oversee spending annually an amount equal to one-fourth of the Gross National Product, and they manage a \$2 trillion cash flow, \$900 million in annual contract payments, a payroll and benefit systems for five million civilian and military personnel, and a budget with 1,962 separate accounts. Altogether, in 1988, the federal government operated 253 separate financial management systems.¹⁰

This scope and complexity in financial management systems has created a multitude of problems, some of which have been recognized for some time. For example, OMB concluded that federal financial management focused inordinately on budgeting to the neglect of other financial management systems. Wright says: "We found federal financial management focused on budgeting and neglectful of cash,

credit, and financial management systems."¹¹ Before reform could take place, considerable groundwork had to be undertaken. For example, as early as 1981, OMB had identified the following problems:

- Failure to establish federal credit policy for programs totaling more than \$50 billion in direct and guaranteed loan portfolios. Total delinquent debt was computed by OMB at \$30 billion in FY80 and was projected to grow at a rate of 43.6% annually.

- Absence of a government-wide cash management system. The government could not receive or make payment by electronic funds transfer and 30% of federal payments to firms were late, while 45% were made too early.

- A proliferation of financial management systems. Almost 400 financial systems were in use and many were antiquated, incompatible, and redundant.

- Insufficient awareness of the need for internal controls to prevent fraud, theft, diversion or misuse of funds and federal assets.

- Little connection between budget and accounting data existed and very little management information was available to measure the impact and benefits of spending.¹²

To combat these problems the Reagan Administration introduced Reform 88, a program intended to improve the financial integrity of

government. Reform 88 and congressional efforts in the 1980's led to a number of financial management improvements, including passage of the prompt payment and debt collection acts, and improved accuracy of cash management position estimation. A 30-day bill paying standard was established along with electronic funds transfer and direct deposit capability. Use of credit cards to pay for services provided to government was initiated. Further, 311 accounts in 50 agencies were converted to a nation-wide lockbox system. Annual cash flow through lockboxes increased to over \$26 billion by FY90. Additionally, electronic collection of funds owed the government through the Fedwire Deposit System exceeds \$280 billion annually.¹³

Improved credit practices also were instituted, including use of credit reports to screen federal loan applicants. Federal loan program collection performance was improved through the use of salary and tax refund offsets, private collection firms, and prosecution for delinquent debt by the Justice Department. Over \$839 million was collected from the tax refund offset program in three years. Also, an OMB requirement that each federal agency have a single, primary accounting system addressed the issue of duplicate and redundant systems, and aggressive efforts have been made to convince smaller agencies to use systems at larger agencies.

Most of the initiatives noted above were begun in the Executive Branch after consultation with appropriate committees of Congress, the GAO, and department and agency representatives.

Initial policy typically was announced by Executive order, OMB circular, or other directive based on Presidential authority. Congress followed up on these initiatives with oversight hearings, the most important of which were convened by the House Government Operations Committee and the Senate Government Affairs Committee. Meanwhile, federal departments and agencies had an opportunity to experiment with alternative methods of implementation. Congress and the Executive branch evaluated these alternatives, often with the aid of GAO or agency Inspector General audits. A consensus emerged from this process of experimentation in the 1980's that CFO legislation was needed to better co-ordinate and direct financial management reform. However, the decade of the 1980's ended without agreement between Congress and the Executive Branch on the specifics of such legislation.

Congressional Action Leading to Passage of the CFO Act of 1990

Testimony given before the Committee on Government Operations in the fall of 1988 focused on three problem areas for financial management reform legislation: management failures and inconsistencies, accounting systems and internal controls, and audited financial statements.

Management failures and inconsistencies: The Committee concluded that decision makers at all levels of the federal government were not getting the financial information they needed to make policy and management decisions with sufficient knowledge of the ultimate financial impact of those decisions. Too many important decisions were made based on rudimentary cash flow

projection and "check book balancing" with insufficient consideration given to the qualitative nature of expenditures and future costs and liabilities.¹⁴ An inevitable outcome of excessive concentration on outlays and cash management was executive and congressional struggle over short-term budget targets and outlay rates.

Congressional testimony indicated that the financial decision making process was inhibited because financial management functions were split within the Executive branch between OMB, the Department of the Treasury, and the General Services Administration. Since these control agencies have overlapping responsibilities for oversight and direction of financial management operations, it has been difficult to sustain reform initiatives, despite repeated efforts to assume this responsibility by OMB. Congress concluded, as had the Executive, that a Chief Financial Officer of the United States was needed to provide centralized leadership for federal financial management.

Considerable debate ensued in Congress and within the Executive Branch over whether to locate the federal government's Chief Financial Officer in OMB or in the Department of the Treasury. The final decision favored OMB.

"Ultimately, the Committee decided OMB was the best location; as the management and budget power center for the Federal Government, it is better positioned to establish government-wide policies to achieve financial management reforms. Treasury, on the other hand, with its large staff at the Financial Management Service, was viewed as best suited to continue its operational support role for financial management efforts."¹⁵

Accounting Systems and internal controls:

As explained by OMB and cited in Government Operations hearings, "Once a leader in the early days of automation, the Government's financial systems and operations have eroded to the point that they do not meet generally accepted accounting standards."¹⁶ Congress concluded from testimony that the federal government was managing today's financial challenges with yesterday's technology and that without modern accounting systems, financial managers could not perform their jobs well. Costs associated with servicing, upgrading and replacing antiquated systems were estimated in the billions of dollars. While accounting systems and internal controls have been strengthened somewhat in recent years, continued deficiencies have serious consequences. For example¹⁷:

- In making multimillion dollar program funding decisions, Congress must rely on Selected Acquisition Reports that may not provide an accurate or timely reflection of program costs and schedule variances for major weapons systems.

- Weakness in agency debt collection systems are significant and delinquencies in non-tax debt owed the federal government grew by 167% from 1981 through FY87 to \$32 billion.

- For 10 years DoD has not been able to account adequately to Congress and GAO for hundreds of millions of dollars of advances made by foreign customers for weapons system purchases.

- Financial audits routinely uncover weak controls which permit, for example, over \$50 million in undetected fraudulent insurance claims at the Federal Crop Insurance Corporation, or excessive rate charging by the Rural Telephone Bank.

- In reports required by the Financial Integrity Act, 17 of 18 agencies disclosed significant weaknesses in financial management and associated areas.

- Between 1982 and 1988, DoD received about \$55 billion more for anticipated inflation than was warranted by the inflation that subsequently occurred. According to the Department of Defense, for example, most of the inflation dividends were cut by Congress, spent on defense programs, or lapsed and returned

to the Treasury. Since these funds have not been fully monitored and accounted for, the full disposition of inflation funds has not been determined by Congress.

The Committee on Government Affairs concluded that the absence of timely, relevant, and comprehensive financial information, and persistent internal control weaknesses compounded the difficulty of controlling government operations and costs. One approach presented in hearings suggested that the government adopt the same accounting principles employed by businesses and many governments -- Generally Accepted Accounting Principles, or GAAP.¹⁸

The federal government employs a cash basis budgeting and accounting system to measure spending. It was argued that instituting GAAP rules would move the process toward capital budgeting and accrual accounting. GAAP has been developed to provide users of financial documents with improved understanding of financial data for reporting and decision-making. "Most importantly, GAAP recognizes liabilities as they are incurred and associates the cost of assets with the period during which they are utilized or consumed."¹⁹ Conversely, under GAAP assets such as federal buildings or equipment would be recognized as capital items with specific values and rates of depreciation. The advantage advocated in congressional hearings from using GAAP was that decision makers would be given a more complete and accurate picture of government finance than they currently receive from the cash-basis snapshot. For example, on a balance sheet using GAAP, the construction of a new building would not appear as a one time debit with no future benefit, as it does now on a cash basis. Instead, the full value of

the building over its entire life would be recognized by budget decision makers.

GAAP also would make it more difficult for OMB, federal agencies (and Congress for that matter) to manipulate budget entitlement accounts. For example, trust fund accounts in surplus often are added into the unified budget to offset deficits in other areas of the budget. Other practices such as the shifting of pay days from one fiscal year to the next to meet outlay ceilings would not be necessary under accrual accounting. Under GAAP financial statements, such "games" would be unnecessary and implausible because liabilities appear on the balance sheet, regardless of when they must be paid.

Audited financial statements: The Committee was impressed by testimony indicating that a key element of financial management reform would be strengthened and expanded financial reporting through the development of audited annual financial statements. Financial statements provide a scorecard for an agency and subjecting them to the rigors of an independent audit would, it was argued, instill discipline in financial systems and strengthen accountability. Bowsheer testified that financial statement audits ensure that "accounting transactions, accounting systems, financial statements and financial reporting to Treasury, OMB, the Public, and the Congress are properly linked."²⁰

Audited financial statements are used and have proven successful at the federal agency level as well as in state and local governments. The Social Security Administration published its

1988 annual report including audited financial statements that attempted full disclosure of financial information on agency administered programs. These financial statements attested to the financial soundness of the social security system. In another instance, audited financial statements were said to have proven their worth by detecting serious financial problems. When GAO audited the Federal Savings and Loan Insurance Corporation using accrual based accounting, it showed a \$13.7 billion deficit. The cash-based audit for the same period reflected a substantial surplus.²¹

The Chief Financial Officers Act of 1990

Amidst the turmoil in Congress over budget deficit control and the chaos of the annual authorization and appropriations cycle, the Chief Financial Officers Act of 1990 was enacted into law under the sponsorship of Senator Glenn in relative obscurity late in August.²² The CFO Act seeks to strengthen the general and financial management practices of the federal government in order to make government operations more efficient and effective. It is intended to provide, "...accounting, financial management, and internal controls to assure the issuance of reliable financial information to deter fraud, waste and abuse of Government resources." ²³ The thrust of the Act is to strengthen financial operations throughout the federal government by:

1. Increasing financial management oversight responsibili-

ties of the Office of Management and Budget (OMB) by creating a Chief Financial Officer for the federal government.

2. Creating Chief Financial Officers in 23 different federal departments and agencies.

3. Creating a CFO Council, to advise and assist with implementation of the Act.

4. Requiring agencies to submit a proposal for consolidating accounting, budgeting, and other financial management functions under their agency CFO.

5. Requiring the submission of five year plans describing the implementation of the consolidation from each agency.

6. Mandating an annual audited financial statement.

7. Requiring annual management reports.

The CFO Act established a centralized financial management structure within OMB and in major departments and agencies. This structure is headed by a new Deputy Director for Management and Finance in OMB, who is also the Chief Financial Officer of the United States. The Act also created the Office of Federal Financial Management in OMB, headed by a Controller who serves as deputy for the CFO.²⁴ The CFO and Controller preside over a network of agency CFO's located in the 14 departments and 9 major agencies of the executive branch.

The CFO of the United States is appointed by the President, with the advice and consent of the Senate. As Deputy Director for Management, the CFO is charged to "provide overall direction and leadership to the executive branch on financial management matters

by establishing financial management policies and requirements, and by monitoring the establishment and operation of Federal Government financial management systems."²⁵ Essentially, the CFO is tasked to provide the framework and guidelines indicating how the government should implement financial management improvements. This is to be done by specifying the type and form of information that will be produced by the government's financial management systems, identifying projects that will accomplish systems integration, and estimating the costs of the plan. Annual reports to Congress are required to sustain attention on the reform process.

Within individual agencies, CFO's report directly to the head of the agency regarding all financial management matters. CFO's oversee all financial management activities relating to programs and operations of the agency and they are to develop and maintain integrated agency accounting and financial management systems, including those for reporting and financial controls. CFO's are to direct, manage, and provide policy guidance and oversight of financial management personnel, activities, and operations.²⁶ They also are charged with monitoring the financial execution of the budget.

Agency Chief Financial Officers are appointed by the President or designated by agency heads, as required by law, and must possess demonstrated knowledge, ability, and extensive practical experience in the financial management practices in large business or governmental entities.

The CFO Act also requires preparation of an annual management

report. This is to include an overview and narrative discussion and analysis of the agency's financial operations. Four schedules are to be included in the report:

1. a statement of financial position
2. a statement of operations
3. a cash flow statement
4. a statement of reconciliation to budget

Supplemental statements as appropriate may be submitted to identify performance criteria or to provide other information by major programs, activities, or funds.

The calendar established for implementing the CFO Act for reporting of FY 1992 data is as follows:

Preparation of FY91 financial statements by	12/31/91
Submission of statements to OMB	3/31/92
Completion of audit of financial statements	6/30/92
Submission of annual report to OMB	8/31/92
Submission of annual report by OMB to Congress	9/30/92

While to the casual observer the implementation of this process may appear unduly complicated, the magnitude and diversity of federal financial activities ought not to be underestimated. Departments and agencies have experienced a number of problems both in preparing financial statements and in auditing those statements.

The statutory provisions establishing CFO's and the annual report are the central focus of the Act, but additional requirements are intertwined in the fabric of the law. These include:

1. Preparation of five year financial management systems

improvement plans both government-wide and in all 23 agencies covered by the Act.

2. Audits of financial statements holding agency heads accountable for their operations.

3. Annual reporting by OMB and departments to the President and Congress on the status of financial management in the federal government.

The Five Year Financial Plan requirement in the CFO Act stipulates that agencies describe their existing financial management structure and identify the changes needed to integrate financial management systems. The plan is supposed to provide a strategy, bring current systems into compliance with the provisions of the Act, eliminate duplicative systems, and integrate existing financial management systems.²⁷ Agencies must provide a plan for the annual preparation and audit of financial statements; they also must provide an estimate of the costs for implementing the proposed five-year plan.

Issues and Problems in Implementing the CFO Act

Not surprisingly, many challenges face government officials charged with the enormous task of implementation of the CFO Act. Evidence to date indicates agencies are focusing on defining the requirements of the Act, determining qualifications and roles for the newly appointed CFO's, and identifying impediments to implementation²⁸. It is clear that the changes in government operating procedures required to comply with the CFO Act will not

be inexpensive. While not all of the implications of the Act can be foreseen, some of the more difficult and sensitive issues are evident. These include the qualifications of CFO's, CFO Act implementation costs, standards and authority, content of financial statements, and the scope of audits including performance measurement. These issues are summarized below.

Qualifications for CFO's: The myriad of responsibilities consolidated under the CFO requires that those who fill these positions have broad financial management experience. The CFO Act specifies the basic qualification standards, but it goes further by requiring that OMB develop and maintain additional qualification standards for agency CFOs and Deputy CFOs. The Act clearly intends for the CFO to exert a leadership role with the deputy as the technical expert. The provisions of the Act also make it advantageous for CFO's and deputies to be experienced as comptrollers, financial managers, to be skilled in financial management systems design, and to have working knowledge of procurement, human resource management and regulatory policy. As explained by federal CFO Frank Hodsoll: "If an agency has an equivalent official in place who can effectively carry out the CFO role, he or she should be considered for the CFO appointment."²⁹ While there are some executives in government who satisfy these demands, some candidates may not measure up to these demanding standards. Congressional displeasure with some of the candidates proposed by departments and agencies was evidenced in late 1991 when Senator Glenn complained about nominees from Health and Human Services and the Department of

Agriculture, " The enormous job of cleaning up the books and hauling the government into the modern financial management age cannot be undertaken by just any political appointee looking to polish a resume."³⁰

In addition to finding qualified CFO's, the federal government faces a formidable task in training and educating a new generation of skilled financial managers. This endeavor must begin at the point of hiring new employees and continue as a career-long investment. As noted by the House report which accompanied the CFO Act:

"The Federal Government must compete for the top college graduates and provide them a career path that is professionally and financially rewarding. Investments must be made to ensure that employees maintain, and even increase, their professional skills to help the government keep pace with emerging technology and developments in financial management."³¹

CFO Act Implementation Costs: The sweeping accounting and information system changes required by the Act will not come cheaply. While all of the implementation costs have not been quantified, OMB identified its 1992 budget requirements related to the Act as \$104.4 million for audited financial statements, including \$31 million for the preparation of the statements, and \$73.4 million for audits of statements. This \$104.4 million request is large compared to the \$10 million provided in the FY91 budget for audited financial statements.³² One conclusion is obvious, continued pressure for funding must be applied within and by the Executive branch to sustain these initiatives.

Standards and Authority: Significant questions remain unresolved

concerning the standards upon which the CFO Act relies and who has the authority to set standards. Nominally, CFO standards refer to the Budget and Accounting Act of 1950, Title II, which gives GAO the power to set accounting standards. However, *Bowsher vs. Synar*, the test of *Gramm-Rudman-Hollings I* in 1986 which declared unconstitutional the function of GAO in *GRH I* to instruct the President how much to cut from the budget to meet deficit targets appears to have given the power to define suitable accounting standards to the executive branch. As noted subsequently, the task of developing accounting standards for the federal government has been assigned to the Federal Accounting Standards Advisory Board (FASAB).

Form and content of financial statements: A prototype CFO Act financial statement was prepared by the Department of the Treasury to assist departments in complying with the new law. Further, OMB has asked the CFO Council to develop model financial statements. By August 1991, financial statements had been prepared and audited for the General Services Administration, Social Security Administration, the Veterans Administration, and the Department of Labor. In general, the law requires financial statements for business-like activities or those that have substantial commercial-type activities. These statements are to follow the guidelines in Title II, and where agency standards depart from those guidelines, agencies are to provide full disclosure. The Department of Defense, for example, has chosen to stagger the implementation of the financial statements. Audited financial statements will begin in FY 1991 for

DOD revolving and trust funds. The Army (for FY 1991 through FY 1993 reports) and Air Force (for FY 1992 and FY 1993 reports) are included in pilot projects requiring the audit of all accounts and funds. The Navy industrial fund and stock fund will also be included in FY 1991 reports. Certain defense-wide agencies will also be included, including the Defense Stock Fund, and the Defense Military Retirement Trust Fund. These will be prepared by the agencies and audited by each Military Department Audit Service as well as by the Department of Defense Inspector General, in cooperation with GAO.

Three points with respect to financial statements may be observed. First, the ability of the statement to withstand government and independent outside audit is critical. The CFO Act requires the Inspectors General to certify the accuracy of data in financial statements. An implementation task force has been established to study and make recommendations on implementation. Secondly, some activities do not lend themselves well to a financial statement approach in that they are public good oriented, e.g., 'maintaining the Grand Canyon.' Thus, the more traditionally business-like functions of government have been undertaken first. Thirdly, notwithstanding the experience of a few agencies with audited financial statements, their practical utility has not yet been proven and many methodological questions need to be addressed.³³ Clearly, financial statements are needed for business-type activities such as those in real estate transactions, credit programs, and trust and revolving funds. However, the usefulness of

financial statements for other more public goods type government activities is worthy of debate. Statements of profit and loss may not make much sense for many government programs. Further complications include questions of asset classification and valuation, liability reporting, accounting systems adequacy and creation of the basic form and content of financial statements. Another concern is that budgetary decisions might be skewed to favor capital investments over human investments.

Finally, a range of problems in financial statement preparation is driven by inconsistencies in accounting systems procedures--even in the same agencies--and inconsistencies in accounting standards, e.g., cash and accrual. Agencies may lack information in accounting systems to produce disclosure statements. Also, there is some disagreement about when to make a disclosure, as well as what it should be. Some agencies report a lack of documentation for reported general ledger balances. Auditors of financial statements will encounter somewhat different problems, including a lack of audit trails for individual transactions and an absence of information in accounting systems to identify assets, especially for personal property. In general, there is an absence of complete documentation for accounting systems and weakness in specifications for internal control procedures and systems in many federal departments and agencies. For example, as a result of the GAO audit, the Department of Agriculture reported to Congress they no longer have confidence that their internal controls are adequate to protect the interest of the nation. In another example, DOD and

GAO are in substantial disagreement over inventory control methods, with one of the problems being end items and how they are counted: the Army has three ways to count tanks, depending on what answer is desired and how the data are to be used. The end user has controls against theft, but GAO wants to know the dollar value, as does Congress. Furthermore, DOD officials fear that GAO will use the leverage of the CFO Act and financial statement requirements in pursuit of its own agenda with Congress, e.g. attempting to reinforce its indictment of DOD mismanagement of inventories.

With respect to the issuance of financial statement standards, OMB, GAO and the Treasury Department have created the Federal Accounting Standards Advisory Board(FASAB)³⁴ to accomplish this task with significant department and agency input. For the long term, however, OMB has until June 1993 to submit a report to Congress detailing the costs and benefits of a pilot program of agency-wide audited financial statements.

It is hoped that most definitional problems will be solved by the process initiated by FASAB. The mission for FASAB is to consider and recommend accounting standards and principles for the federal government. The Board is made up of one GAO member, one OMB member, one Treasury member, one Congressional Budget Office member, one member from the Defense and International Agencies, one member from the civilian agencies and three non-federal members selected from the general financial community. FASAB concept statements are intended to explain the concepts and methods that the Board will use in recommending standards, and statements about

accounting standards provide accounting guidance to federal agencies through exposure drafts.

The Board has a difficult task ahead of it, since there remain some pressing questions about accounting standards for the federal government, questions about the value of assets, about the valuation of inventories, and about depreciation. Some of the definitions for these terms make sense if the only purpose of the organization is to spend money; depreciation, for example, is an important concept, but DOD would not make a decision to build a new warplane based solely on the depreciation value of the comparable warplane now in service. Nonetheless, the complete financial statement process does put more attention on what government does and what it costs to do it.

Scope of Audits and Performance Measurement: OMB guidance on the scope of audits needed to meet the intent of the Act prescribes that, at minimum, audits should provide an opinion on the adequacy of statements, a report on internal controls, and a report on compliance with laws materially affecting the statements. Additionally, pressure from Congress has been exerted to expand audits to encompass performance measures at each activity, and OMB has responded as noted subsequently. These requirements will increase the value of audits considerably, but will create significant difficulty in implementation as well. In effect, OMB requirements convert each financial audit into a financial/performance audit requiring great care in sampling, testing and evaluation.³⁵ Audits on this scale, accompanied by untested and unrefined financial

statements, may overwhelm the experience base of departments, agencies, GAO, the Inspectors General, and Congress.

In February 1992, OMB Executive Deputy Director for Financial Management Frank Hodsoll (the federal CFO) issued a memorandum for department chief financial officers providing guidance on preparation annual financial statements.³⁶ The memorandum requested departments to submit financial statements for FY 1991 financial activity to OMB by March 31, 1992. This memorandum supplemented OMB Bulletin 91-15, Guidance on Form and Content of Financial Statements on FY 1991 Financial Activity that specified five parts for statements: overview, principal statements, notes to principal statements, combining statements where appropriate, and supplemental financial and management information.³⁷ The memorandum noted that the guidance for FY 1991 statements would also provide the basis for preparation of FY 1992 statements, with some anticipated modifications based upon experience with the 1991 effort and advice from the CFO Council.

The key element of the February 1992 guidance, however, is the inclusion of ...appropriate performance measures [to]...ensure the utility of financial statements...Such measures will assist program managers in assessing the efficiency and effectiveness of their programs and designing actions to correct problems; they will also facilitate relevant comparisons among similar programs.³⁸ The memorandum initiated an interagency effort to identify and define common program performance and financial performance measures. The interagency project is intended to identify major program activi-

ties subject to CFO Act reporting, establish a team for each activity with representatives from agencies engaging in the activity, and tasking teams to select performance measures for each activity that ...the activity would find useful. ³⁹

The goal of this initiative is to develop common and agency specific performance measures for major government-funded activities by May 1992. OMB identified candidate programs and preliminary performance measures as a "starting point" to guide agency efforts. Fourteen major activities were selected by OMB staff. ⁴⁰ Principal agencies for each activity team also were indicated.

In the February 1992 memorandum, Hodsoll also noted that OMB had been engaged in research on performance measurement and reporting in state and local government and foreign governments, and was cooperating with Congress in the development of legislation; one such measure is a Senate bill (S.20) sponsored by Senator Roth as the "Federal Program Performance and Goals Act." The General Accounting Office also has surveyed federal agency performance measurement and the Department of the Treasury staff are studying performance measurement in private industry.

Several observations may be made in addition to those offered previously with respect to performance measurement under the CFO Act. First, most federal departments and agencies currently employ performance measurement in some fashion. Performance measures and the measurement processes are audited (e.g., by the GAO and Inspectors General) and are reviewed by congressional oversight committees annually. However, despite efforts by the federal

government to develop and use performance measures in budgets and elsewhere since the 1950's, there are no uniform standards for performance measurement methodology across the government. Perhaps, given substantial differences in mission and goals between federal departments and agencies, such standards are not needed.

Additionally, there is no compelling evidence that Congress uses the performance data it receives in great volume with any degree of effectiveness. Despite this fact, most public administrators would endorse the concept of performance measurement, particularly if it is integrated into budgeting. Some departments have implemented such approaches. The Department of Defense, for example, now uses a cost-reimbursement methodology based upon unit performance measures in its new \$70 billion Defense Business Operating Fund initiated in FY 1992. To the extent the proposed Roth legislation and OMB impose new performance measures rather than permitting the incorporation of existing methodologies, this would add to the existing paperwork and audit trail burden of government. If anything, the federal government probably is over-audited relative to state and local government and existing law forces its employees to spend too much time on accountability-oriented paperwork.

Despite this circumstance, the principal flaw in federal performance measurement efforts to date seem to be in integrating existing performance data into budgeting. Federal departments and agencies tend to blame this on Congress for its failure to use such data when provided in actual appropriation committee decision

making. This is not to say that these data are not employed usefully by other committees. In fairness to Congress, OMB and executive departments also have an equal responsibility to use performance measurement in budgeting.

Finally, it should be noted that poor performance measurement is probably worse than none at all because bad measures produce poor resource management decisions and impair the operating efficiency of government. Unless good, accurate measures are developed and used in budgeting and elsewhere, well-intended efforts to improve performance measurement probably are in vain due to absence of perceived utility on the part of those who must implement the CFO Act at the agency level.

Conclusions

The CFO Act incorporates many of the principles and concepts developed over four decades to reform federal financial management. First, it establishes a primary accountable official in the person of the statutory Chief Financial Officers. Secondly, it puts a powerful financial management organizational structure in place with 23 CFO's reporting directly to the heads of departments and agencies, and then to OMB and Congress. Thirdly, it requires agencies to develop financial management plans and produce annual progress reports. Fourth, it sets the stage to move toward financial statements that classify costs by program, providing corresponding measures of program performance, and projecting future liabilities and returns on investments.

While the passage of the CFO Act represents a major step

forward to improve the quality of federal financial management, it also presents many challenges in the monumental task of implementation to meet the goals of its authors. For most federal departments and agencies, this Act will change many of their procedures in accounting, budgeting and budget execution. In a period of burgeoning deficits, better financial control cannot help but increase confidence in government while it also decreases the actual cost of government.

Part of the intent of the CFO Act is to strengthen the authority of OMB to leverage federal departments and agencies to make improvements in financial management. On the basis of the guidelines issued by OMB over the past year implementing the Act, it is evident that the intent of Congress and the Executive regarding the role of OMB is being met. Department CFO's have observed that OMB is exhibiting new teeth in the issuance of requirements and timetables that must be complied with by federal agencies. Although most departments were given until 1992 to submit FY1991 financial statements as prescribed by the law, OMB has not been as flexible with other provisions of CFO requirements.

Another fact has become evident as the CFO Act is implemented: the process for development of financial reporting and accounting standards through FASAB is dominated by accountants, accountability concerns and a private sector approach to reporting rather than by budget officials and attention to the ties between accounting, reporting and government budgeting. In development of accounting standards this bias appears to be warranted. However, in order for

financial statements to become valuable for decision making it is imperative that they translate into the primary method by which financial decisions are made in the nation's capital, i.e., the budget and budgetary process. Unless financial reports crosswalk easily into the appropriation format there is a risk that such statements will not fulfill the expectations of reformers who believe that better preparation and reporting of financial data will result in better financial management decision making. Department representatives have reminded FASAB task group members that financial statements need to integrate accounting and budgeting data in the financial statement, but it is not clear yet whether this message has been received.

Furthermore, it is important for those implementing the CFO Act to realize that significant improvements in decision making are not insured merely as a result of having better data. For example, even if data are available to indicate the long-term impact of a capital outlay decision made today, there is no guarantee that traditional criteria for prioritizing spending decisions will not continue to prevail in the Executive branch and in Congress. The power of constituent interests tends to outweigh net present value comparisons and cost/benefit ratios in the politics of the budgetary process. Additionally, real advancements in financial management are unlikely to result alone from the standardization of accounting and reporting standards or performance measures across the federal government. Rather, such improvements rely first on the development of better and more sophisticated financial systems in

departments and agencies--which cannot be mandated by Congress or OMB. Second, the CFO structure and the financial statements must prove their worth. How will they improve federal financial management? How will financial statements improve financial decision making? Will statements showing unfunded liabilities for example affect appropriation decisions?

There is some initial evidence to suggest that leadership in Congress wants to uphold its responsibilities under the CFO Act. Senator Glenn and Representative Conyers and their staffs recognize the linkages necessary between internal controls (e.g., as required by the FMFIA), Inspector General reporting and certification, the budget, and the annual financial statements. Furthermore, congressional and Executive branch leadership also appear to recognize the sequential nature of accomplishments required to successfully implement the CFO Act: establishment of the CFO organization structure and individual CFO accountability, institution of methods to assure the accuracy of financial statements, development and application of performance measures, and integration of financial statements with the federal budget. And, because CFO implementation is scheduled for review by Congress in 1993 as prescribed under the financial statements portion of the Act, congressional oversight attention is a certainty.

The keys to improving financial systems are expertise, sustained financial systems development, and support for this development from Congress, the President, OMB and department and agency executives. Perhaps the most important factor is sustained

executive level support for financial system development, integration, standardization and consolidation at the department level in the face of predictable bureaucratic resistance and unanticipated costs. The goals of the CFO Act are clear, but many choices have to be made in departments regarding the most systematic, appropriate and cost-effective methods for implementing these goals. Pressure from OMB to implement the provisions of the CFO Act and codification of accounting and performance standards appear to be necessary but not sufficient conditions for the achievement of meaningful federal financial management reform.

1. For example, other legislation designed to improve financial management at the federal level included the Federal Managers Financial Integrity Act, the Inspector General Act, the Debt Collection Act, the Prompt Payment Act, the Single Audit Act, the Federal Grant and Cooperative Agreement Act, the Competition in Contracting Act, the Debt Collection Act and the Intergovernmental Cooperation Act. Statement of John L. Lordan, p. 216. Hearings on Improving Federal Financial Management, House of Representatives, Committee on Government Operations, Sub-Committee on Legislation and National Security. 100th Congress, 2nd Session, September 22, 1988. Washington:USGPO, 1989. (Hereafter cited as "Hearing.")

2. House of Representatives Report no. 101-818, 101st Congress, 2d Sess., pt. 1., Chief Financial Officer Act of 1990, p. 14, (Hereinafter cited as "Report").

3. Elmer Staats, "Financial Management Improvements: An Agenda for Federal Managers," Public Budgeting and Finance, 1/1, 1981: 44.

4. Staats. 1981" 54.

5. Charles Bowsher, "Government Financial Management at the Crossroads: The Choice is Between Reactive and Productive Financial Management," Public Finance, 5/2, 1985: 11.

6. Bowsher, 1985: P 21.

7. Gerald Riso, "Role of the Federal Chief Financial Officer," Public Budgeting and Finance, 8/3, 1988: 55-62.

8. Riso, 1988: 55.
9. Statement by Senator John Glenn as quoted by Riso, 1988: 56.
10. Statement of Joseph R. Wright, Jr. Deputy Director, Office of Management and Budget. Hearing p. 150.
11. Wright, Hearing, p. 136.
12. Wright, Hearing, pp. 136-137
13. Wright, Hearing, p. 140. The estimate for 1988 was \$286 billion.
14. Statement of Hon. Joseph J. DioGuardi, N.Y. Hearing, p. 38. Representative DioGuardi had been a CPA for 22 years and a Congressman for four at the time of this hearing.
15. Report p. 16.
16. Statement of Charles A. Bowsher, Comptroller General, Hearing, p. 58.
17. Bowsher, Hearing, p. 59-60. See also Financial Integrity Act: Continuing Efforts Needed to Improve Internal Controls and Accounting Systems. GAO/AFMD-88-10, December 30, 1987.
18. See R.K. Mautz, "Generally Accepted Accounting Principles," Public Budgeting and Finance, 11/4, 1991: 3-11.
19. DioGuardi, Hearing, p. 45.
20. Bowsher, Hearing, p. 69.
21. Statement of Hon. Rep. Larry E. Craig, Idaho, Hearing, p. 25.
22. One source claimed that it was enacted "at midnight, in August, and the Appropriations Committee Chairman didn't discover it until four months later." While this is doubtless hyperbole, it does indicate how quietly the bill made its passage into law. In June 1990 the Chairman of the House Appropriations Committee who opposed the CFO legislation attempted to halt its implementation by placing language in appropriations law to, in effect, invalidate the CFO Act. However, the full House of Representatives refused to sustain the Chairman's actions. Subsequently, however, the Appropriations Committee did cut some of the money requested for implementation of the financial statement audit provisions of the Act.
23. The Chief Financial Officer Act of 1990, P. L. 101-576 (199-0), (104 Stat. 2838) Nov. 15, 1990., p. 2, (Hereinafter cited as "Act").

24. The Office of Federal Financial Management has been structured in four divisions: Cash and Credit Management, Financial Systems, Financial Standards and Reporting, and Management Integrity. The responsibilities of the Management Integrity Division include implementing the Federal Managers Financial Integrity Act (FMFIA) passed by Congress in 1982.

25. Act Sec. 202.

26. For example, the agency CFO is charged with reviewing fees, royalties, rents, and other reimbursable charges.

27. All four military departments in DOD have different systems for paying temporary employees; differences are as small as one accounting down to the 1/4 hour and the others not. A standing joke in almost any federal department of any size begins, "There are 180 different accounting systems in the federal government, 250 in this agency alone . . ."

28. An example of how the CFO ACT was implemented, in the Department of Defense, the Comptroller was appointed as DOD's Chief Financial Officer on January 7, 1991. On April 15, 1991, the Deputy Comptroller for Management Systems was appointed Deputy Chief Financial Officer. DOD's proposed implementation plan was approved by OMB on May 24, 1991. Since DOD had already begun a consolidation of finance and accounting activities, the CFO90 did not lead to further changes at the military department level, although minor modifications to the Comptroller's charter and some realignment of duties within the office of DOD Comptroller may still be necessary.

29. Frank Hodsoll, "Office of Management and Budget's Plans for Implementation of the Chief Financial Officers Act," Government Accountants Journal, Spring 1991, p. 14.

30. Senator John Glenn, as quoted in "Fixing Financial Management." Government Executive, 24/2 (February 1992): 9.

31. Report, p. 17.

32. Hodsell, p. 14.

33. An audit of the Social Security Administration employing performance measures has been accomplished, and the Inspector General of the Department of Health and Human Services prepared financial statements for funds totaling approximately \$70 billion that were regarded as successful by OMB.

34. See Robert W. Bramlett, " The Federal Accounting Standards Advisory Board," Public Budgeting and Finance, 11/4 1991:11-19.

35. Sherman Funk, "The CFO Act: Kudos and Caveats," Governments Accountants Journal, Spring 1991, p. 8.

36. Frank Hodsoll, "Memorandum for Chief Financial Officers, Office of Management and Budget, February 5, 1992.

37. Hodsoll, 1992: 1.

38. Hodsoll, 1992: 1.

39. Hodsoll, 1992: 2.

40. The fourteen activities are management of federal property, real estate sale under loan/insurance programs, insurance, pensions and social insurance, loans and loan guarantees, leases, product sales, supply operations, electric energy, medical care, health and safety regulations, enforcement regulations, market development, research and development.

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