



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

Embargoed Until 2:30 a.m. (EDT), June 26, 2008

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FISCAL ASSISTANT SECRETARY KENNETH E. CARFINE TESTIMONY BEFORE THE SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY

WASHINGTON – Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to this hearing to discuss the Financial Report of the United States Government (Financial Report) for Fiscal Year 2007. Your interest in improving Federal financial management and, in particular, fiscal sustainability is appreciated. The Financial Report, incorporating the consolidated government-wide financial statements, is designed to report on the financial position and condition of the federal government pursuant to generally accepted accounting principles (GAAP).

The Financial Report reflects Treasury's long-standing responsibility to provide the Congress and the public with timely, reliable, and useful information on the cost of the government's operations, the sources used to fund them, and the implications of the government's financial commitments. It is designed to encompass and does substantially cover the financial results of all three branches of the federal government. Treasury constantly strives to improve the utility and value of the Report as well as the process by which it is produced.

This year, all 24 CFO Act agencies published their audited financial statements by November 15, and we issued the government-wide Report approximately a month later on December 17. These timely submissions are evidence that both the Federal agencies and Treasury continue to improve their systems and processes. As I will discuss, these improvements notwithstanding, due to long-standing material weaknesses, the Government Accountability Office again issued a disclaimer of opinion on most of the statements in the Financial Report. However, this year's report brings with it two significant achievements: 1) an unqualified audit opinion on the Statement of Social Insurance and 2) the issuance of a Citizen's Guide to the Report.

Highlights from the Financial Report

As Treasury and OMB reported in October, for Fiscal Year 2007, revenues increased to a record level of \$2.6 trillion—an 8 percent increase over the previous fiscal year. Consequently, the 2007 federal net operating cost of \$276 billion was better than anticipated and was a significant improvement over the 2006 net operating cost of \$450 billion.

The Government's balance sheet shows that its liabilities exceed its assets by more than \$9 trillion dollars. Much of this difference is attributed to: 1) the government's debt to the public of more than \$5 trillion and 2) another nearly \$5 trillion in anticipated federal employee and veterans postemployment benefits and commitments for which funding (i.e., employee and employer contributions) has not yet been obtained. The Statement of Net Cost presents cost by agency.

Because the Budget Deficit is such a well-publicized and generally-accepted figure, we provide two statements that facilitate the comparison and reconciliation of the government's activity. The Reconciliation of Net Operating Cost and the Unified Budget Deficit statement ties the more widely recognized budget results (e.g., \$163 billion unified budget deficit) to the government's net operating cost of \$276 billion.

The budget deficit and net operating cost differ because the government uses a different basis of accounting for each. The budget is prepared generally on a cash basis, which more appropriately pertains to the inflow and outflow of funds during the fiscal year, regardless of the amount or nature of the transaction. By comparison, the government's audited financial statements are prepared generally on the accrual basis pursuant to GAAP promulgated by the Federal Accounting Standards Advisory Board. Accrual accounting recognizes revenues when earned—not necessarily collected; and expenses when incurred—not necessarily expended. The bulk of this difference is due to the inclusion of actuarial increases in both federal employee pension and health liabilities, and environmental liabilities in net operating cost, but not in the budget deficit.

The Report also contains a Statement of Social Insurance (SOSI), which shows the present value cost of the government's exposures of its social insurance programs, primarily Social Security and Medicare. As indicated earlier, the SOSI became the first and, to date, the only government-wide financial statement to receive an unqualified audit opinion from the Government Accountability Office (GAO).

The FY 2007 Report adds new information related to fiscal sustainability. It provides a discussion of the extent to which the government will be able to financially support its critical programs in the near and distant future. This discussion is largely based on the information contained in the SOSI as well as the government's stewardship report (which is drawn from the Social Security and Medicare Trustees Reports).

Regarding the Social Security program, an important milestone was reached this year when the first baby boomers began drawing retirement benefits from Social Security. The retirement of the baby boom generation will have a profound impact on the finances of Social Security and Medicare. There are currently 3.3 covered workers per Social Security beneficiary; that number will fall to 2.1 by 2034. Medicare faces the same demographic challenges as Social Security, but

additionally must cope with the rapid expected growth in health care costs. While Social Security expenditures are expected to grow considerably over the next 75 years, from 4.3 percent of GDP in 2007 to 6.3 percent of GDP in 2081, Medicare's expenditure growth is expected to increase from 3.2 percent of GDP in 2007 to 11.3 percent of GDP in 2081.

From a government-wide perspective, Medicare obligations are expected to dwarf those of Social Security. The 75-year present value of projected Medicare expenditures less tax and premium revenue is \$34 trillion (4.7 percent of the present value of GDP), rising to \$36 trillion in the 2008 report, while the 75-year present value of projected Social Security expenditures less tax revenue is \$4.7 trillion (0.6 percent of GDP).

The Financial Report shows that the Federal Government's current policies, particularly with respect to Social Security and Medicare, are unlikely to be sustainable. Total expenditures, including interest, are expected to grow to 50 percent of GDP by 2070 and 60 percent by 2080. Such spending levels have only been witnessed once before—during World War II, when Government expenditures reached a then-record high of 44 percent of GDP. If revenues in the future continue at the historical average level of 18 percent of GDP, they will barely cover 1/3 of total government expenditures and would not be sufficient to cover the net interest on the Government's debt.

The consequence of the projected growing gap between revenues and expenditures would be a rapidly-increasing debt-to-GDP ratio. By 2030, the need to fund government deficits will drive the debt-to-GDP ratio to 68 percent—far surpassing the non-wartime peak of 49 percent in 1993. By 2040, this ratio is projected to reach 128 percent, well above the World War II peak of 109 percent. Thereafter, the ratio of debt held by the public to GDP rises sharply to 300 percent by 2060, doubling again to 600 percent by 2080. A rapidly rising debt-to-GDP ratio creates uncertainty over the form of future government financing, portends adverse long-run consequences for the economy and could impact other countries' willingness to lend money to or invest in the United States.

As noted earlier, these are merely projections based on a myriad of assumptions that can change and alter the outlook. Yet, the projections provide an important signal about the difficulties that the Government faces in attempting to sustain current policies. The Government can neither reasonably grow into nor tax its way back to sustainability. Nor can it realistically expect to continue to borrow without incurring a substantial negative impact on the economy. Avoiding the consequences of this fiscal path will require actions to bring program expenditures in line with available resources. How soon those actions are taken will greatly influence their ultimate impact on the Nation.

Addressing the Auditor's Findings

For Fiscal Year 2007, GAO was unable to express an opinion on the financial statements, due to long-standing material weaknesses. I recognize that until our financial statements can withstand audit scrutiny, we will not benefit from the Report's full value in informing the Congress and the Public about the Government's fiscal position and condition.

We agree with GAO on the following three principal material weaknesses:

1. Serious financial management control issues at the Department of Defense,
2. The government's inability to properly eliminate transactions between agencies, and
3. The government's deficiencies in the process for preparing the consolidated financial statements.

GAO raised many valid points in its audit, and there is no one more than I who would like to see a "clean" audit opinion on the consolidated financial statements. Across government, we have been addressing the weaknesses relating to the elimination of intragovernmental balances and the report preparation process, and are making progress.

We concur with GAO that the out-of-balance condition, resulting from intragovernmental transactions, continues to represent a significant material weakness. This occurs when two agencies conducting business with each other as trading partners record and report the same transaction differently. We are addressing this issue in several ways:

- We have started requiring significantly greater detail from the agencies. In addition, we have developed tools to track the imbalances, identify the problems, analyze the data, and implement solutions. We have also formed inter-agency groups to examine each pair of related transactions to resolve the imbalances.
- Partnering with OMB, we developed a method and vehicle to report these inter-agency transactions throughout the government. Agencies use these reports, which are posted on the Web, to analyze their transactions and balances. We have also worked with OMB to develop a "watch list" of agencies with the largest intragovernmental differences.
- We worked with the CFO Council to develop new intragovernmental transaction "business rules," which are helping to bring about more consistent accounting among business partners. Finally, we require agency auditors to review the intragovernmental balances in the hope that greater auditor involvement will encourage agencies to accurately record these transactions and correct the imbalances.

These and other actions have reduced the differences in reporting intragovernmental transactions from \$86 billion in FY 2006 to approximately \$67 billion in FY 2007.

We continue to address the report preparation issues by developing and following corrective action plans, which include strategies for short-term and long-term solutions. At the beginning of this fiscal year, there were 81 outstanding recommendations from GAO for improving the internal controls over the report preparation process. This year, we closed out 35 recommendations relating to prior year's reports. Based on the audit of the 2007 report, GAO identified an additional 10 recommendations for improving the report preparation process bringing the current total recommendations to be resolved to 56. Our plan is to resolve 8 of the 10 new recommendations by the end of the fiscal year and continue to aggressively address the 46 prior years' findings and recommendations.

We have strengthened our report preparation processes, by enhancing our data collection systems to meet disclosure requirements prescribed by generally accepted accounting principles. We have also focused our attention and resources on improving and fully documenting our standard operating procedures to increase the efficiency and effectiveness of our processes. Additionally, we have continued to enhance and clarify our guidance to federal program agencies for accurate and complete information and to ensure consistency of agency information for the Financial Report.

The Federal Government's Financial Health: A Citizen's Guide

A common critique of the Financial Report of the U.S. Government is that, despite the fact that it contains more than 180 pages of detailed information on the government's financial position and condition, it is not a practical document for communicating with the American citizen or the Congress. At a minimum, the Report should provide an opportunity for all interested parties to easily gain an understanding of the significant fiscal challenges that the federal government faces now and in the future. In 2005, the Treasury Department consulted with a number of communication and accountability reporting experts (including some international colleagues) to identify ways to improve the Report's informative value and, more importantly, its ability to communicate with the general public.

In response, for the first time, the Treasury Department and OMB, in cooperation with GAO developed and issued a summary report entitled, *The Government's Financial Health—A Citizen's Guide to the Financial Report of the U.S. Government*. This Guide provides a summary of the key data and issues addressed in the full report in a "user-friendly" manner to the general public. We attempted to minimize the use of detailed technical and political jargon to make it easy to read. We have made a point of sharing this document not only with members of Congress, but also educational institutions around the country and in public professional forums. The document is eight pages in length and while printing was limited, it is freely accessible on the Internet. We have received valuable feedback, thus far, and are looking forward to improving on the Guide in subsequent editions.

As the primary investors in our country, U.S. citizens are entitled to, and our government is obligated to provide, up-to-date financial performance results about the government's current and future financial health. It is our hope that this document is the first of many of its kind—and that it sparks interest not only among committee members but the general public and encourages continued discussion of these important issues.

Outlook for Financial Reporting

I am committed to working with OMB and the Chief Financial Officers Council on developing the government's financial management strategy for the near future. The improvements in financial systems and business processes that many agencies have made as a result of audited financial statements and accelerated timelines has led to better underlying financial data. We are now looking toward improving efficiency through standard systems and processes and a common language and structure for exchanging information and financial data among agencies and between agencies and Treasury.

Conclusion

The process of producing the Financial Report of the U.S. Government and annual agency financial reports and the reports themselves can have an impact on improving management and control of the government's finances. However, these reports are of limited or even minimal value if they go unread. As such, in addition to continuing to pursue resolution of the Government's financial reporting weaknesses, this year, the Treasury focused on how to make the document and the information that it contains more relevant and useful to the general public. We believe that the Citizen's Guide is a solid first step and hope that its visibility will inspire the public to ask questions about the government's and our own financial future. Thank you, Mr. Chairman. This concludes my formal remarks. I look forward to your questions.