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# Audited Financial Statements:

## Getting and Sustaining

## "Clean" Opinions


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The PricewaterhouseCoopers Endowment for

# The Business of Government

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# Foreword

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On behalf of The PricewaterhouseCoopers Endowment for The Business of Government, we are pleased to present this report by Douglas A. Brook, "Audited Financial Statements: Getting and Sustaining 'Clean' Opinions." It is the first major study to analyze factors that contribute to agencies receiving unqualified ("clean") opinions and those receiving qualified or disclaimed opinions.

This report describes the impact of managerial and organizational factors on the ability of federal government agencies to receive and sustain "clean" audit opinions. Five case studies of agencies are presented. By drawing on the experience of specific federal agencies and analyzing financial reports from numerous other agencies, the author shares management lessons that are applicable to all federal agencies working toward obtaining and sustaining "clean" opinions.

The report prescribes key roles that an agency's leadership can take to assist agencies to obtain and sustain "clean" opinions. Specifically, the report recommends that agency leadership be involved in the agency's financial management process, help redirect resources if needed, and communicate the importance of "clean" opinions to employees and stakeholders. In addition, the author notes that several agencies have been successful after undertaking a "heroic effort" to produce a "clean" opinions.

We believe that this report will provide all agencies with specific, practicable recommendations for achieving and sustaining annual "clean" opinions. Achieving and sustaining "clean" audit opinions are key steps in aligning agency financial operations with overall performance and successful program outcomes.

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# Executive Summary

The requirement for federal agencies to prepare business-style financial statements and subject these statements to independent audit was the centerpiece of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. This report examines how organizational factors and management strategies can affect the ability of federal agencies to meet these requirements and achieve unqualified ("clean") audit opinions.

Some financial management organizational factors, such as the number of financial management systems, the number of reporting entities, and the duties of the chief financial officer (CFO), are found to relate to the frequency and distribution of clean audit opinions, but none is found to be an absolute barrier to success. Looking for other explanations for the differences in agency audit opinions, the research identifies six management strategies that are found in most agencies with successful audit histories. They are leadership support, positive resource allocations, constructive partnerships with auditors, cooperation with functional and line managers, short-term systems solutions, and extraordinary effort.

These findings have important implications for heads of agencies and CFOs in the new administration. Agency efforts to get and keep clean audit opinions should be supported by policies and practices that make use of the six key management strategies.

The report makes seven recommendations:

1. The White House, OMB, and heads of agencies must exhibit tangible interest and involvement in financial reporting.
2. Agency budget decisions and personnel allocations must recognize that audited financial reporting is a recurring requirement.
3. CFOs and inspector general auditors should establish ongoing collaborative approaches to financial reporting and audits.
4. Agency leaders need to demonstrate that audited financial statements and clean audit opinions are agency-wide priorities in order to encourage cooperation by functional and line managers.
5. Short-term systems solutions should be employed to help bring the remaining agencies up to a clean audit opinion where integration of new core accounting systems are delayed or under long-term development.
6. "Heroic effort" should be employed in instances where agencies need to overcome one-time data collection hurdles or to overcome temporary shortcomings in financial information or reporting.
7. Agency leaders, chief financial officers, and inspectors general must recognize that producing reliable financial statements is a recurring annual requirement.

# Introduction

The requirement for federal agencies to begin preparing business-style financial statements and subject them to independent audit was the centerpiece of the Chief Financial Officers Act of 1990. The Government Management Reform Act of 1994 extended the requirement for audited financial statements to 24 departments and agencies, representing nearly 98 percent of the total federal budget.* Further, it directed the secretary of the treasury and the director of the Office of Management and Budget (OMB) to develop a consolidated government-wide financial statement subject to audit by the Comptroller General. These new financial reporting requirements were designed to subject federal government agencies to the same type of audited financial reporting as in the private sector. This research examines how organizational factors and management strategies affect the ability of federal agencies to generate reliable information for financial statements and achieve unqualified audit opinions.

## About This Study

Some have argued that certain organizational characteristics can affect the ability of agencies to produce reliable financial information. This research report examines some key financial management organizational characteristics to determine whether there is any correlation between these attributes and the audit opinions on the Fiscal Year (FY) 1996-1999 financial statements of the 24 Government Management Reform Act (GMRA) agencies. The findings indicate the extent to which financial management organizational factors may facilitate or inhibit achievement of clean audit opinions.

Unless organizational factors explain all of the differences in the frequency and distribution of unqualified opinions, some other factors must influence the outcome. A likely explanation lies in the management strategies and tactics that agencies have employed. This research identifies six approaches that successful agencies have employed.

## Research Questions and Research Design

This research was undertaken to determine the relationship between certain organizational and managerial factors and the achievement of unqualified ("clean") audit opinions. Initial ideas were developed through suggestions from the following sources about what may be important in getting a clean audit opinion: (1) statements made in testimony before congressional committees by proponents and opponents of the CFO Act; (2) observations and concerns expressed by auditors and others charged with oversight of CFO Act implementation; (3) opinions expressed by financial managers in interviews and conversations with the author.

** The requirements for audited financial statements come from both the CFO Act and the Government Management Reform Act. For the sake of brevity, and as commonly used, the term "CFO Act" will be used to reference the financial reporting requirements of both laws.*

Then, three approaches were taken. First, an extensive archival review of government documents and reports and other public records provided an initial collection of useful data. Second, confidential, nonattributable interviews were conducted with senior government financial managers who were participants in CFO Act implementation. Third, illustrative analyses and case studies of selected agencies were undertaken. Using more than one research technique allowed for opportunities to test and illustrate the findings of each approach.

The audit opinions considered in this study are those of the 24 departments and agencies that were required to prepare audited financial statements by the Government Management Reform Act. The period considered is the four-year span covering fiscal years 1996 through 1999; that is, four annual financial statements for each agency over the period from Oct. 1, 1995, to Sept. 30, 1999. The distribution and frequency of audit opinions for a total of 96 audited financial statements are considered.

# Financial Information in the Public and Private Sectors

The Chief Financial Officers Act of 1990 mandated major changes in the management and reporting of financial affairs in the federal government. The most visible change under the act is the requirement for federal agencies to issue financial reports that conform largely to standard practices in the private sector.

What are the purposes of financial reports in business and government? Who uses the information? In the private sector, financial statements present the financial condition of the enterprise. Since the enterprise exists to be financially sound and profitable, business financial reports are representations of financial health, viability, and success. Outsiders such as stockholders, creditors, government regulators, customers, suppliers, and investors use this information to make economic decisions, such as whether to do business with, or invest in, the organization. The independent audit attests to the reliability of the information presented.[1]

Financial reporting in the public sector is somewhat different. The goal of financial reporting in government is to provide "(1) financial information useful for making economic, political, and social decisions and demonstrating accountability and stewardship; and (2) information useful for evaluating managerial and organizational performance."[2]

[1] *O. Ray Whittington and Kurt Pany,* Principles of Auditing, *(Boston: Irwin McGraw-Hill, 1998), 6.*

The purpose of an independent audit is also somewhat broader in government. "Audit of government reporting is an essential element of public control and accountability.... Financial auditing provides independent reports on whether an entity's financial information is presented fairly and/or on its internal controls and compliance with laws and regulations."[3] Government financial statements are intended more for use by insiders to identify weaknesses in management practices and systems, target areas for administrative reform, and improve program performance.

## History of Federal Financial Management Reform

Efforts by Congress to regulate financial management and accounting in the executive branch of the federal government date, at least, to the Dockery Act of 1894, which sought to install auditing and simplify financial management accounting and structure. Modern efforts to reform and set standards for financial management and accounting, as listed in Table 1, date from the Budget and Accounting Act of 1921. The act created a budget system for the federal government, and established two new financial agencies—the Bureau of the

[2] *John Glynn,* Public Sector Finance and Accounting, *(Oxford: Basil Blackwell, 1987), 8.*

[3] *United States General Accounting Office,* Government Auditing Standards: 1994 Revision, *(Washington: USGAO, 1994), 10.*

**Table 1: Major Federal Financial Management and Accounting Legislation**

| | | |
|---|---|---|
| 1921 | Budget and Accounting Act | Created the General Accounting Office (GAO). Also created the Bureau of Budget (BOB) in the Department of the Treasury. Under the Reorganization Plan No. 1 of 1939, BOB moved to Executive Office of the President |
| 1950 | Budget and Accounting Procedures Act | Assigned management and reporting to executive branch and auditing to GAO |
| 1956 | Public Law 84-863 | Consistency in accounting and budgeting |
| 1970 | Reorganization Plan No. 2 | Reorganized the Bureau of the Budget within the Executive Office of the President and renamed it the Office of Management and Budget |
| 1978 | Inspector General Act (amended in 1988) | Created independent audit entities in major departments and agencies |
| 1982 | Federal Managers Financial Integrity Act | Standards for internal accounting and administrative controls |
| 1990 | Chief Financial Officers Act | Mandated agency CFOs and began audited financial statements |
| 1990 | Federal Credit Reform Act | Required accounting for credit programs on a budget basis similar to other federal spending |
| 1993 | Government Performance and Results Act | Standards for reporting program performance and results |
| 1994 | Government Management Reform Act | Expanded CFO Act financial statement requirements, mandated consolidated and audited government financial statements |
| 1996 | Federal Financial Management Improvement Act | Standard accounting and systems, compliance reporting |

*Source: Cornelius Tierney,* Federal Accounting Handbook, *25-40; U.S. Congress, House Committee on Government Reform,* Making the Federal Government Accountable: Enforcing the Mandate for Effective Financial Management, *29-33.*

Budget in the executive branch (originally in the Treasury Department), and the General Accounting Office (GAO) as an agency of the legislative branch. The Budget and Accounting Procedures Act of 1950 gave the comptroller general the responsibility for prescribing accounting and auditing principles and standards, and it assigned responsibility for maintenance of accounting systems and preparation of financial reports to the executive branch. Congress sought to achieve "full disclosure of results of government financial operations, adequate financial information for operating and budgetary purposes, and more effective control over receipts, expenditures, funds, property, and other government assets."[4]

Public Law 84-863 of 1956 amended these two acts to achieve better consistency and conformity in accounting and budgeting.

[4] *Cornelius Tierney,* Federal Accounting Handbook, *(New York: John Wiley, 2000), 31.*

In 1978, the Inspector General Act created independent audit organizations in major departments and agencies to focus mainly on rooting out fraud, waste, and abuse. Amendments in 1988 broadened the powers of the Inspectors General (IG) and positioned them for eventual responsibility to audit agency financial statements.

The Federal Managers Financial Integrity Act of 1982 (FMFIA) amended the 1950 act to improve the internal accounting and administrative controls in executive branch financial management. It authorized the GAO to set standards and required annual reports to Congress on agency compliance with prescribed standards.

As this chronology indicates, there is a history of occasional congressional interest in financial and accounting standards and financial reporting, but nothing that matches the intensity of reform in the 1990s.

This past decade was marked by a series of financial and administrative reforms, beginning with the CFO Act of 1990. "By establishing a financial management leadership structure, requiring audited financial statements and strengthening accountability reporting, the CFO Act laid the groundwork for comprehensive financial management reform."[5] The CFO Act was followed by the Government Performance and Results Act of 1993 (GPRA), which sought to improve program performance through the development and reporting of comparable information on program outcomes, outputs, and activities measured against program goals and evaluation. The Government Management Reform Act of 1994 expanded the financial reporting requirements of the CFO Act and mandated preparation of an audited consolidated financial statement for the federal government. The Federal Financial Management Improvement Act of 1996 required agencies to conform with accounting and financial management systems standards, use a standard general ledger, and report compliance, material weaknesses, and remediation plans.

## The Chief Financial Officers Act of 1990

The goal of the CFO Act was "to create reliable, relevant financial and performance information for sound management decisions about programs, budgets and fiscal stewardship, all of which should lead to higher performance."[6] The findings section of the CFO Act states three purposes: (1) more effective general and financial management practices; (2) improvement of systems of accounting, financial management, and internal controls; and (3) production of reliable, timely, and consistent financial information for use by the executive branch and Congress in the financing, management, and evaluation of federal programs.[7] The requirement for audited financial statements was meant to serve four general managerial and informational purposes, for internal and external users. First, the process of preparing financial statements and submitting them to audit is believed to lead to better financial management. Better financial systems, accounting standards, and financial performance will be driven by the legal requirement to prepare and audit agency financial statements. A second managerial purpose is to provide reliable financial information that can be used more broadly to manage agencies better. "The act was designed to make the federal government, through its agencies, function in a more efficient and business-like manner."[8] "The audience for federal agencies' statements is interested in how effectively agency managers are using the resources made available."[9] A third purpose is to make reliable financial information available for decision-makers in government to encourage better program and resource allocation decisions. "The budget should be formulated using accurate and reliable financial data on actual spending and program performance. Audited financial statements ought to be the source of these data."[10] Fourth, financial information is intended for citizens to use, holding government accountable for the stewardship of their resources.

The Chief Financial Officers Act of 1990 (P.L.101-576), enacted Nov. 15, 1990, contained the following major provisions:

- Established a deputy director for management within OMB to be responsible for financial management in the federal government and created an OMB Office of Federal Financial Management headed by a controller.

- Mandated chief financial officers for major departments and agencies and established a Chief Financial Officers Council to coordinate financial management reform efforts among the agencies.

[5] *Anonymous, "A Brief History of Reform,"* Government Executive, *vol. 30 no. 6 (June 1998): 44.*

[6] *Tracey G. Amos, Cynthia A. Paolillo and Denise A. Joseph, "Enhancing CFO, GMRA and GPRA Implementation With Activity-Based Management,"* The Government Accountants Journal, *vol. 46 no. 1 (Spring 1997): 28.*

[7] *P. L. 101-576, Title I, Section 102.*

[8] *Statement of Buel T. Adams, U.S. Congress, House, Committee on Government Reform and Oversight, Subcommittee on Government Management, Information, and Technology,* Hearing: Chief Financial Officers Act Oversight, *July 25, 1995, (Washington: GPO, 1996), 156.*

[9] *Statement of Francis D. DeGeorge, U.S. Congress, House, Committee on Government Operations, Subcommittee on Legislation and National Security,* Hearing: Improving Federal Financial Management, *September 22, 1988, (Washington: GPO 1989), 260.*

[10] *Statement of Charles A. Bowsher, U.S. Congress, House, Committee on Government Reform and Oversight. Subcommittee on Government Management, Information, and Technology,* Hearing: Federal Budget Process Reform, *March 27, 1996 (Washington: GPO, 1997), 305.*

- Required OMB, departments, and agencies to develop plans for improving financial management systems.

- Established a 10-agency pilot program for preparation of audited agency-wide financial statements.

- Required audited financial statements for trust funds, revolving funds, and commercial-type activities (i.e., the most "businesslike" government entities and those most likely to be able to produce auditable financial statements), as well as both audits and management reports for government corporations.

The 10-agency pilot program, in which designated agencies were required to produce business-style financial statements and subject these statements to independent audit, was the first test of whether federal government agencies could be subject "to the same kinds of audited financial reporting that have long been required in the private sector."[11] Prior to enactment of the CFO Act, most government agencies had no requirement or need to produce business-style financial reports. Rather, financial management concentrated on budgetary matters —budget development, defense, and execution. Overall statements of financial condition had no apparent role in the annual budget process and little obvious relationship to program performance. Many agencies, therefore, found that their financial accounting and reporting systems, having heretofore been geared toward budgetary reporting requirements, were incapable of providing the needed information, in the required format, and in a timely manner, to satisfy the new requirements.

## The Government Management Reform Act of 1994

Unlike the CFO Act, the Government Management Reform Act of 1994 (P.L.103-356) did not deal exclusively with financial management. Instead, it was a collection of diverse administrative reforms. Section 405 of Title 4 of GMRA extended the CFO Act requirement for agency financial statements to 24 departments and agencies representing nearly 98 percent of the total federal budget. Further, it directed the secretary of the treasury and the director of OMB to develop a consolidated government-wide financial statement subject to audit by the comptroller general.

## Audit Opinions

What does an unqualified, or "clean," audit opinion mean? The auditor's opinion that accompanies an organization's financial statement is an attestation as to whether management's assertions in the financial statement are a fair representation based on reasonable criteria (i.e., accepted accounting principles). This assertion is based on a review of the organization's financial documents, financial management policies and procedures, internal controls, etc. There are four types of audit opinions.

| | |
|---|---|
| Unqualified ("Clean"): | Auditors are reasonably sure that the financial statements are presented in conformity with accepted standards. |
| Qualified: | Auditors are reasonably sure of fair representation "except for" or "subject to" some stated conditions. |
| Adverse: | Auditors believe financial information is not stated fairly to such a significant degree that the statements are misleading. |
| Disclaimed: | Auditors cannot gather sufficient evidence to reach an opinion about the reliability of the financial statement.[12] |

As shown in Table 2, within the total of 120 audit opinions between FY '96 and FY '00, there are 62 unqualified opinions, 23 qualified opinions, and 35 disclaimed opinions. No agency has received an adverse opinion. Twenty departments and agencies achieved at least one unqualified opinion, and four have never had a clean opinion. Five agencies have unqualified opinions for all five years, and three have received five straight disclaimed opinions. Eleven show improvement and have sustained their audit opinions at the best levels that they have attained. Five others have nonlinear audit histories,

[11] *Albert Gore,* From Red Tape to Results, Creating a Government That Works Better and Costs Less: Resource Book, (Accompanying Report of the National Performance Review), *(Washington, GPO, 1993).*

[12] *O. Ray Whittington and Kurt Pany,* Principles of Auditing, *12th Edition, (Boston: Irwin McGraw-Hill, 1998), 2-3, 678.*

having achieved an unsustainable level of audit opinion and then slipped to a worse opinion in a succeeding year.

What is the importance of achieving a clean audit opinion? Why should one care if agencies can produce auditable financial statements? Clean audits are an important threshold issue. This is to say, the higher uses to which financial information can be put depend upon the information being reliable. If better financial management, better agency management, better government performance, better resource allocation decisions, and better accountability are to be achieved through the use of the information in financial statements, the users have to believe that the information is reliable. Future financial management and resource allocation decisions may likely depend on confidence in the quality and accuracy of financial information contained in agency financial reports. Understanding how and why some agencies have achieved unqualified audit opinions should either suggest how others can do likewise, or expose the limitations of this reform.

**Table 2: Audit Opinions on Agency Financial Statements**

| Organization | 1996 | 1997 | 1998 | 1999 | 2000 | Total "clean" opinions |
|---|---|---|---|---|---|---|
| USDA | D | D | D | D | D | 0 |
| COMMERCE | D | D | D | U | U | 2 |
| DEFENSE | D | D | D | D | D | 0 |
| EDUCATION | D | U | D | Q | Q | 1 |
| ENERGY | U | U | Q | U | U | 4 |
| HHS | D | Q | Q | U | U | 2 |
| HUD | Q | Q | U | D | U | 2 |
| INTERIOR | Q | U | U | U | U | 4 |
| JUSTICE | D | D | D | Q | Q | 0 |
| LABOR | Q | U | U | U | U | 4 |
| STATE | Q | U | U | U | U | 4 |
| DOT | D | D | D | U | Q | 1 |
| TREASURY | D | Q | Q | Q | U | 1 |
| VA | Q | Q | Q | U | U | 2 |
| AID | D | D | D | D | D | 0 |
| EPA | Q | U | U | Q | U | 3 |
| FEMA | D | D | U | U | U | 3 |
| GSA | U | U | U | U | U | 5 |
| NASA | U | U | U | U | U | 5 |
| NRC | U | U | U | U | U | 5 |
| NSF | Q | Q | U | U | U | 3 |
| OPM | D | D | D | D | U | 1 |
| SBA | U | U | U | U | U | 5 |
| SSA | U | U | U | U | U | 5 |

U = Unqualified ("Clean") opinion
Q = Qualified opinion
D = Disclaimed opinion

*Sources: 1999 Financial Report of the United State Government (USGAO AIMD-00-131): p. 14; Jason Peckenpaugh, "Agencies Turn In Audits On Time—And Most Pass Muster,"* Government Executive, *March 6, 2001.*

# Case Studies

To explore these issues in greater detail, case studies were developed for five agencies. Two research techniques were used. First, key agency documents were reviewed, including financial statements, *Accountability Reports*, internal memoranda and instructions, reports to senior management, presentations, reports to OMB, tracking logs, time lines, significant events, milestones, etc. Second, confidential, not-for-attribution interviews and discussions were held with present and former financial managers, program managers, and IG auditors.

The agencies selected for illustration are taken from each of the four categories of audit history. They are the Small Business Administration (consistent unqualified opinions), the Department of Veterans Affairs and the U.S. Coast Guard (improvement), Department of the Army, (consistent disclaimers), and the Department of Education (inconsistent).

## Small Business Administration

The U.S. Small Business Administration (SBA) was created as an independent agency in 1953. Its mission is to "help maintain and strengthen the nation's economy by counseling, assisting, and protecting the interests of small businesses and by helping businesses and families recover from disasters."[13] The agency operates mostly through its credit and business assistance programs. In FY 1999, it provided over $14 billion in total lending for small businesses and also provided over 40,000 loan guarantees.

**Audit Opinions**

The SBA has achieved consistent unqualified opinions since FY 1996. It had been producing audited financial statements for six years prior, however, achieving five straight qualified opinions. The agency's auditors, a small independent auditing firm, qualified the FY 1995 report due to problems with the reconciliation of fund balances with the Treasury, and inventories relating to foreclosed properties. In the FY 1996 audit report, four internal control weaknesses were cited, but SBA had made enough significant progress in resolving the qualification issues to receive an unqualified opinion on its FY 1996 financial statements.[14] In succeeding years, the SBA has maintained its clean opinions and reduced its material weaknesses to three in FY 1998 and two in FY 1999. Administrator Aida Alvarez explained, "This good record reflects the priority that the SBA has placed on improved financial management since the enactment of the CFO Act of 1990."[15]

[13] *U.S. Small Business Administration,* Accountability Report, *Fiscal 1999: Helping Small Businesses, (Washington: Small Business Administration, 2000), 4.*

[14] *U.S. Small Business Administration, "Audit of SBA's FY 1996 Financial Statements,"* FY 1996 Financial Statements, *(Washington: SBA, 1997), 1.*

[15] *U.S. Small Business Administration, "Message from the Administrator,"* Accountability Report, Fiscal 1999: Helping Small Businesses, *(Washington: Small Business Administration, 2000), i.*

**Management Strategies and Tactics**

How did the SBA achieve its unqualified opinion and what strategies has it employed to sustain its financial reporting at that level? Some SBA financial managers cite the interest of Erskine Bowles, administrator in the early 1990s, as causing the quest for a clean opinion to be an entity-wide priority. Administrator Bowles had a strong background in business and finance and he paid attention to the SBA's books. The administrators who followed, Phil Lader and Aida Alvarez, continued the top-level support for improved financial management.

The SBA's challenge was to overcome the two problem areas that were being qualified by the auditors, particularly in the area of cash reconciliations. It attacked these problems by applying additional resources and contracting with a small minority firm in a two-year effort, assigning three people to work at the agency's Denver finance center. At the same time, the relationship with the auditor expanded into a collaboration. Monthly meetings accelerated into biweekly meetings during the fall audit cycle, producing a process that helped the SBA develop a plan to attack audit issues and material weaknesses in cooperation with both the outside auditors and the IG staff. The SBA also installed a new cash reconciliation system, though it still found it necessary to use some Excel spreadsheets and manual systems while new automated systems, and eventually a new core financial system, were being developed. SBA has now procured an integrated commercial off-the-shelf (COTS) financial management package that will eliminate the remaining manual and spreadsheet applications and replace the current financial management systems. In addition, the resources for preparing financial statements have become part of the agency's base budget for the office of the CFO.

The SBA now views its clean opinions and the reliability of its financial reports to be especially important for the accountability and image of a banking-type agency. The SBA is the first credit agency with five consecutive clean audit opinions. In addition, the SBA has eliminated all material weaknesses and has become fully compliant with the Federal Financial Management Improvement Act (FFMIA).

This brief look at an agency with consistently clean opinions illustrates many key management strategies and tactics. Senior leadership commitment, combined with positive resourcing, extraordinary effort, and short-term systems strategies, were employed to overcome the auditors' qualifications and achieve the first clean opinion. Since then, entity-wide cooperation and the partnership between financial managers and auditors have helped to sustain the effort while long-term improvements to the core financial systems are developed and brought on line.

## Department of Veterans Affairs

The Department of Veterans Affairs (DVA) was established in 1989 when Cabinet status was granted to the over 50-year-old Veterans Administration (VA). Its statutory mission is "to administer the laws providing benefits and other services to veterans and their dependents and the beneficiaries of veterans."[16]

Operationally, the department functions through three separate administrations, each headed by an undersecretary. The Veterans Health Administration employed 186,595 (FTE) and expended $17.6 billion in FY 1999. It provides medical care, research, and medical education in hospitals and medical centers throughout the nation. The Veterans Benefits Administration administers the DVA's compensation and pension programs, vocational counseling and rehabilitation services, and education, insurance, and housing programs. In FY 1999, it employed 6,841 FTE and expended $21.6 billion in benefit and administrative costs. The National Cemetery Administration operates cemeteries, makes grants to state veterans' cemeteries, supervises interments, and provides headstones and grave markers. In FY 1999, it employed 1,357 FTE and expended $2.2 billion in benefits and administrative costs.[17]

**Audit Opinions**

The Department of Veterans Affairs was one of the 10 agencies designated in the CFO Act to participate in a pilot program to produce audited financial statements. Between 1990 and 1995, the audits were conducted by the IG staff except for two areas—veterans benefits and life insurance—that were audited by a private sector CPA firm.

[16] *38 USC Section 301 (b), 1997.*

[17] Ibid.*, 59-67.*

Both received clean opinions. After 1995, funds for contract audits were unavailable and the staff of the department's Office of Inspector General (OIG) conducted all audits of DVA financial statements. The department received qualified audit opinions on its financial statements for FY 1996, 1997, and 1998. In FY 1999, it achieved both a clean opinion for FY '99 and a retroactively clean opinion on the restated financial statement for the previous year.

The DVA's FY 1996 financial statement received a qualified audit opinion. The auditors cited problems in accounting for property, plant, and equipment (PPE), and net receivables. The audit report cited six internal control weaknesses as reportable conditions that could result in future qualifications if not addressed. Reportable conditions are "significant deficiencies in the design or operation of the internal control structure that could adversely affect the ability to record, process, summarize, and report financial data."[18] The reportable conditions were in the areas of PPE records, valuing accounts receivable, canceling unneeded obligations, outdated systems in the life insurance program, information security, and financial accounting in the Housing Credit Assistance (HCA) program.[19]

The audit of the FY 1997 financial statement resulted in another qualified opinion. This time, the OIG auditors reported that they were unable to satisfy themselves as to the recorded balances for receivables, liabilities for loan guarantees, and resources payable to the Treasury. The audit report attributes the inaccurate balances to inadequate accounting records, accounting procedures not being consistently followed, and/or internal controls not operating effectively. Five reportable conditions were cited for FY 1997 in the areas of information security, HCA financial reporting, the HCA direct loan portfolio, guaranteed sales of vendor loans, and on receivables at medical facilities.[20]

Once again, in 1998, the DVA received a qualified audit opinion. The auditors cited problems with the recorded balances for intragovernmental accounts, accounts receivable, liabilities for loan guarantees, and resources payable to the Treasury. The audit report again listed information security, medical facility receivables, and accounting in HCA programs as reportable conditions. It noted, however, that the department expected to complete corrective actions on HCA accounting during FY 1999.[21]

In fiscal year 1999, the DVA finally achieved its first clean audit opinion. Moreover, the auditors revised their opinion on the FY 1998 financial statement. The audit report noted the previous problems with the FY 1998 recorded balances of certain HCA program related accounts and indicated the "the department has restated the statements and we have been able to satisfy ourselves as to these recorded balances."[22] The auditors then went on to give unqualified opinions to both the FY 1998 and FY 1999 financial statements. This is believed to be the only retroactive grant of a clean opinion since the CFO Act first required audited financial statements.

**Management Strategies and Tactics**

How did the Department of Veterans Affairs approach the requirement for audited financial statements and how did it finally get a clean opinion? Interviews with financial managers, program managers, and OIG staff indicate that the DVA employed many of the key management strategies.

The initial organizational response to the requirement for audited financial statements under GMRA placed responsibility for compliance within the CFO organization, with little apparent interest at the top levels of the department. The agency received qualified audit opinions for FY 1996, 1997, and 1998 (later restated). Interviewees routinely described this record as being the product of strong committed management at the CFO and deputy CFO level. The FY 1997 and 1998

[18] *U.S. Department of Veterans Affairs,* FY 1998 Annual Accountability Report, *"Office of Inspector General's Report on the Department of Veterans Affairs Consolidated Financial Statements," (Washington: DVA, 1999), 103.*

[19] *U.S. Department of Veterans Affairs,* FY 1996 Annual Accountability Report, *"Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 1996 and 1995," (Washington: DVA, 1997), 81, 86-91.*

[20] *U.S. Department of Veterans Affairs,* FY 1997 Annual Accountability Report, *"Office of Inspector General's Report on the Department of Veterans Affairs Consolidated Financial Statements," (Washington: DVA, 1998), 92, 94-95.*

[21] *U.S. Department of Veterans Affairs,* FY 1998 Annual Accountability Report, *"Office of Inspector General's Report on the Department of Veterans Affairs Consolidated Financial Statements," (Washington: DVA, 1999), 101,103.*

[22] *U.S. Department of Veterans Affairs,* FY 1999 Annual Accountability Report, *"Office of Inspector General's Report on the Department of Veterans Affairs Consolidated Financial Statements," (Washington: DVA, 2000), 117.*

*Accountability Reports* show little sign that achieving a clean opinion was an organization-wide priority. There is no mention of the audit opinion in the "Message from the Secretary" and no expressed commitment to achieve a clean opinion in the "Management Discussion and Analysis." Referring to this period, one senior financial manager stated, "I never heard anything from the secretary or deputy secretary about a clean opinion. Their total focus was on [operational] matters." The unqualified opinion for FY 1999 and the restated unqualified opinion for FY 1998, however, feature prominently in the secretary's message in the front of the FY 1999 *Accountability Report*. Is this a case of merely highlighting the result of steady progress or did something different happen in 1998-1999 that resulted in achieving a clean opinion?

A single event may have changed the department's approach to financial reporting. On May 26, 1998, President Clinton sent a memo to the heads of all executive departments and agencies (see "Memorandum for the Heads of Executive Departments and Agencies" on p. 16). The memo directed four actions: (1) the Office of Management and Budget will identify noncompliant agencies, monitor their progress toward achieving a clean opinion, and require them to report; (2) agency heads will submit a plan to OMB within two months; (3) agency heads will submit quarterly reports to OMB; and, (4) OMB will submit quarterly reports to the vice president.[23] The Department of Veterans Affairs, having not yet achieved an unqualified opinion, was among those identified for reporting and OMB oversight. The prospect of White House oversight may well have raised the interest level of the department's senior leadership to a higher level that, in turn, resulted in a higher priority effort to secure a clean opinion.

The department's deputy secretary, Hershel W. Gober, signed the first report to OMB, issued on July 30, 1998. Gober's letter identified deficiencies in two funds, HCA and medical care collections, and pledged that "VA fully intends to get a clean opinion on its fiscal 1999 financial statement."[24] The letter included a two-page action plan to address the deficiencies, with 19 milestones ranging from July 1998 to May 1999.

This commitment from the top of the organization had immediate consequences. Available resources were refocused to the effort of getting a clean opinion. HCA was able to secure support from outside contractors, and the Veterans Health Administration reassigned internal resources. Central office staffing was decreased as finance staffs in the administrations were built up. A department-level senior financial manager was detailed as acting CFO in the Veterans Benefits Administration with the approval of senior management in Veterans Benefits Administration, the department CFO, and the secretary of the department. This joint request, approved by the secretary, provided specific authority to manage the effort across organizational lines. The "stovepipes" in the administrations and the department were broken down into teams to address 19 specific milestones for resolving major audit deficiencies. In addition to in-house resources, a contractor with proven experience was hired to be part of the team. New resource allocations were required in the OIG office as well. Operational and program audits were disrupted as financial audits claimed 50 of the 225 FTE personnel on the OIG staff.

CFOs were appointed in each of the administrations, and an internal CFO Council was formed to develop detailed time lines and assign accountability for progress. Monthly meetings were held between the CFO, the deputy CFO, and the head of the OIG audit group. These meetings facilitated the development of a professional, nonconfrontational relationship between the auditors and the financial managers. The CFO staff was then better able to react more quickly and effectively to what the auditors were finding in the field.

The department did not utilize its core financial system to generate the financial statements. The data in the core systems was inadequate. The core general ledger did not include all appropriations. The system needed upgrading. But that would take longer than the department's and OMB's deadlines would tolerate. Instead, the office of the CFO created a huge Excel spreadsheet (called the 90/01 model) into which data for the financial statement was fed. Additional personnel were assigned to conduct reconciliations manually.

[23] *William J. Clinton, "Actions to Further Improve Financial Management,"* Memorandum for the Heads of Executive Departments and Agencies, *(Washington: The White House, May 28, 1998).*

[24] *Letter from Hershel W. Gober, Deputy Secretary of Veterans Affairs to Jacob Lew, Acting Director, Office of Management and Budget, dated July 30, 1998.*

THE WHITE HOUSE

WASHINGTON

May 26, 1998

MEMORANDUM FOR HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES

Subject: Actions to Further Improve Financial Management

My administration has made a significant commitment to achieving the highest standards of financial management and accountability for the American people. Since the enactment of the Government Management Reform Act of 1994, the Federal Government has made substantial progress toward achieving our goals of fiscal discipline and reporting reliability to the American people on the Government's operations and fiscal condition.

An important step in this direction has been the efforts of the Federal Accounting Standards Advisory Board to develop accounting standards for the Federal Government. This effort was consistent with the recommendations of the National Performance Review led by Vice President Gore. These standards formed the basis for the first ever government-wide financial statement of the Federal Government, issued on time on March 31, 1998.

While our financial management program has resulted in significant improvements, there are several areas in which agencies must focus additional attention. Financial auditors reported accounting system weaknesses and problems with fundamental accounting practices across the Federal Government. These specifically include practices related to the Government property, Federal credit programs, liabilities related to the disposal of hazardous waste and remediation of environmental contamination, Federal Government employment-related benefits liabilities, and transactions between Federal entities. My FY 1999 budget request to the Congress outlined my commitment to addressing these problems and obtaining an "unqualified audit opinion"—the highest opinion available from auditors—on the Government's financial statements for FY 1999.

To achieve these goals, I am now directing the additional steps set forth below:

1. The Office of Management and Budget (OMB) shall identify agencies subject to reporting under this memorandum and monitor agency progress towards the goal of obtaining an unqualified audit opinion on the FY 1999 consolidated Federal Government financial statements.

2. The head of each agency identified by the OMB shall submit to the OMB a plan, including milestones, for resolving by September 30, 1999, financial reporting deficiencies identified by the auditors. The initial agency plan is due to the OMB by July 31, 1998.

3. The head of each agency submitting a plan shall provide quarterly reports to the OMB, starting on September 30, 1998, describing progress in meeting the milestones in their action plan. The head of affected agency shall report to the OMB any impediments that would impact the government-wide goal.

4. The OMB shall provide periodic reports to the Vice President on the agency submissions and government-wide actions taken to obtain an unqualified audit opinion of the Government's FY 1999 financial statements.

William J. Clinton

William J. Clinton

These efforts were enough to achieve a clean opinion in FY 1999, but for FY 1998, the Sept. 30, 1998, closing of the books came too quickly. The CFO acknowledged to the OIG that further changes to the numbers in the Credit Reform Program would need to be made before a clean opinion could be expected. An agreement was reached to issue a qualified opinion for FY 1998 and later to restate the financial report when the corrections were in place. Three additional weeks of intensive effort by the OIG auditors resulted in a retroactively clean audit opinion for FY 1998. In his October 1999 quarterly report to OMB, DVA's chief financial officer reported that "all milestones have been completed."[25] The department subsequently received its first on-time, clean audit opinion.

The quest for a clean opinion in the Department of Veterans Affairs provides examples of many of the key management strategies, especially as it allows for some comparison within a single agency between the periods preceding and following the president's memorandum. The effect of leadership commitment is evident, especially as this commitment seemed to change after issuance of the White House directive in 1998. Positive resourcing decisions were made in terms of both the money and personnel needed to achieve a clean opinion in FY 1998 and FY 1999. A short-term "work-around" accounting system was developed to serve the requirements of the financial statement. Extraordinary effort was made in doing manual reconciliations and in restating and extending the audit for the FY 1998 financial statement. Finally, collaborative relationships between the CFO and OIG were established, and a coordinated department-wide effort was undertaken. When these strategies and tactics were fully employed in 1998 and 1999, the department accelerated its progress and achieved unqualified audit opinions.

## U.S. Coast Guard

The U.S. Coast Guard (USCG) is a 210-year-old multimission agency and military service within the Department of Transportation (DOT). The choice of the USCG for a case study offers the opportunity to observe its particularly illustrative approach to getting a clean opinion, and to understand the role of an important subunit of a department-level effort to achieve a clean opinion. The DOT organization includes 12 diverse Operating Administrations. Three DOT entities—the Coast Guard, Highway Trust Fund, and the Federal Aviation Administration—prepare separate audited financial statements that, in turn, become part of the Department of Transportation's consolidated financial statement. As a major element of DOT, the financial operations of the Coast Guard are materially significant for the department. Because of this materiality, DOT cannot achieve a clean opinion on its consolidated financial statement without the USCG "passing" its audit. This case study, therefore, offers a look at the effects of department-wide management strategies that both drive and reinforce those employed by the subunit.

### Audit Opinions

The USCG began preparing financial statements of its commercial-type revolving and trust funds in FY 1992, as required by the CFO Act. In FY 1993, the Department of Transportation's inspector general conducted the first audit of these Coast Guard financial statements, covering about one-third of total Coast Guard funding. Two more years passed before the Coast Guard received a clean audit opinion on its revolving and trust funds.

Audits of financial statements prepared after GMRA cited major problems in properly documenting and valuing property and equipment, documenting and valuing inventories of operating materials and supplies, and technical errors and improper assumptions in actuarial reporting. In tracking six categories of concern—real property, cutters and aircraft, electronics, personal property, operating material and supplies, and actuarial estimates of unfunded retiree pension and medical liabilities—Coast Guard financial managers and auditors identified five as "problem" areas and one as a "caution" in FY 1996. In FY 1997, the list had improved to three "concerns" and three "cautions."

Real improvement started to be seen in FY 1998, with one area "corrected," two "on track" and three "cautions." In FY 1999, the report shows all six areas as "corrected."[26] The Department of Transportation received an unqualified opinion on

[25] *Letter from Edward A. Powell, Jr., Assistant Secretary for Financial Management, Department of Veterans Affairs to Toni Husted, Chief, Veterans Affairs Branch, Office of Management and Budget, dated October 7, 1999.*

the consolidated financial statement, meaning the Coast Guard, as a material entity within DOT, had finally achieved a clean audit opinion, as well. How did the Coast Guard attack these problem areas? What strategies and tactics enabled the USCG to achieve an unqualified audit opinion?

**Management Strategies and Tactics**

In 1996, Admiral James M. Loy, then the Coast Guard chief of staff and today its commandant, made a commitment to Transportation Department CFO Louise Frankel Stoll that the USCG would achieve a clean opinion by FY 1999.[27] Senior level oversight became a constant element in the effort to get a clean opinion, exemplified by Admiral Loy's inclusion of "gaining clean audit opinions in 1999 and 2000" as one of his five management goals communicated throughout the Coast Guard.[28]

The Coast Guard adopted a strategy to achieve a clean audit opinion by FY 1999, even though it meant accepting failing grades on the audits for the intervening two years."[29] The strategy involved leveraging the top-level commitment to allocate resources; achieve cooperation between financial managers, auditors, and operating entities; and to attack the short and long-term systems deficiencies. The USCG short-term strategy was to "treat the symptoms" and "abate the DOT IG audit findings." The long-term strategy was to fix the problems and "move towards a fully integrated financial management system."[30] The effort to get a clean opinion by FY 1999 came to be called a "campaign" and its two senior managers were titled "campaign director" and "campaign manager."[31]

[26] *U.S. Coast Guard, "CFO Audit Preparations," presentation given April 15, 1999, 1.*

[27] *John O'Connor, " 'Passing' the CFO Act Audit of Financial Statements: The Coast Guard Story,"* Armed Forces Comptroller, *vol. 45 no. 2 (Summer 2000): 18.*

[28] *U.S. Coast Guard,* Commandant's Direction, *1998-2002, available at Internet address www.uscg.mil/commandant/direction/excell.html.*

[29] *John O'Connor, " 'Passing' the CFO Act Audit of Financial Statements: The Coast Guard Story,"* Armed Forces Comptroller, *vol. 45 no. 2 (Summer 2000): 18.*

[30] *U.S. Coast Guard, "CFO Audit Preparations," presentation given April 15, 1999, 3.*

[31] *USCG Memorandum from Director of Finance and Procurement to Chief, Office of Financial Systems, and Chief, Office of Financial Management,* Preparations for FY99 CFO Audit, *August 12, 1999.*

The relationship between the auditors and the financial managers was an important element of this strategy. The earlier decision to use DOT IG auditors rather than contract out the audit was an acknowledgment that the IG auditors would know the Coast Guard's business better than any outside auditor would. Since this knowledge came from the IG's traditional program audit experience, this decision could have had either good or bad consequences as far as financial audit opinions were concerned. The IG committed to be "fair and reasonable" and the CFO eschewed any "fool-the-auditor" strategy. A key element of the partnership between financial managers and IG auditors was a written agreement between the USCG and the DOT IG, executed at the start of each year beginning in 1997. These agreements reviewed the material weaknesses found in prior audits and set target dates for resolving the weaknesses. The Coast Guard agreed to make specified records available for audit at the close of the fiscal year. The IG, in turn, agreed to certain procedures and policies affecting issues like documentation, valuation methodologies, and materiality thresholds.[32]

The Coast Guard made an extraordinary effort to get over the largest problems in identifying, counting, and valuing its plant, property, and equipment. Over 100 people were taken off other assignments, such as cost analysis and life-cycle analysis projects, and reassigned to the financial statement campaign. Crews of 10-15 former Coast Guard personnel were deployed for 18-24 month assignments to validate civil engineering real property data and to conduct physical inventories of equipment, supplies, and spare parts. Teams were also sent into the field to research the historical costs of property and buildings. Exhaustive research was required to capitalize newer properties and to value historic properties like Boston Light or property in Puerto Rico that was seized during the Spanish-American War. The auditors, GAO, OMB, and the financial managers agreed to a model based on the Defense Department's triservices model for dealing with "legacy buildings." In addition, the USCG used numerous private sector

[32] Coast Guard and OIG Agreement for Audit of FY 1997, FY 1998 and FY 1999 Financial Statements, *signed by John L. Meche, Deputy AIG for Finance, Economic and Information Technology and William H. Campbell, USCG Chief Financial Officer.*

consulting and accounting organizations to assist with key problem areas. These efforts were essential to the long-term strategy because they provided baselines that were agreed upon by both the CFO and IG organizations. Once the baselines were established, future audits would have to account only for changes, the "puts and takes" that happen over a year.

Some of this effort required achieving the support and cooperation of nonfinancial managers, such as logisticians and operating personnel. Functional commanders were reminded of the commandant's commitment to getting a clean opinion, and the Coast Guard's CFO had budget and procurement authority which sometimes provided the leverage needed to achieve cooperation from reluctant program managers. Utilizing special inventory and valuation teams bypassed the issue of securing "buy-in" on the part of the engineering staff, but once a new system was in place, engineers and financial managers worked together to initialize the database and use the information. For the most part, the Coast Guard is a disciplined force whose culture of cooperation and teamwork is augmented by the fact that its military financial managers pursue dual-track careers, rotating between financial and operational assignments. In addition, the USCG's CFO sought and received authority to issue awards for performance relating to the effort of getting a clean opinion. By the time the unqualified opinion was received, over 100 people had gotten awards, including time off, Special Act cash awards of between $200 and $1,500, superior achievement awards, and military decorations.

Extra effort was also apparent within the office of the department's inspector general. In 1996, over 100 IG staff members were involved in conducting the audit of the DOT's consolidated financial statement. At one point, at least half of the total IG staff had been taken off program and field audits in order to conduct financial audits. The Coast Guard decided not to try building a central, organization-wide, finance and accounting system. Rather it opted to rely on existing business practices, even if they were outside of CFO control, and undertake new systems initiatives only where necessary. Thus, data on deferred maintenance, for example, was drawn from the existing data systems in the field, and partnerships were built with the program managers of the Naval Engineering System. Eventually, a new system was installed to account for inventories of real and personal property, a move that required Coast Guard logisticians to adapt to a new system. Over time, other new systems were installed to replace legacy systems that could not meet the requirements of financial reporting, such as tracking or valuing property, plant, and equipment, or calculating depreciation. At the end of 1999, approximately 80 percent of the Coast Guard accounts were on the new central accounting system managed out of the Coast Guard's national finance center in Chesapeake, Virginia. This centralization of records and systems has resulted in an accounting system that is not burdened by problems which overwhelm the more complex, multifaceted systems in other agencies.

The case study of the U.S. Coast Guard illustrates and validates the previous observations about successful management strategies and tactics. First, leadership commitment and involvement is a very strong factor in the Coast Guard case. The strong motivation by the DOT chief financial officer, the personal commitment of Admiral Loy, as chief of staff and later as commandant, and the persistence of the USCG CFO pervade the entire process. Second, reallocation of human and financial resources occurred in both the Coast Guard and the DOT IG. Third, systems strategies involved the short-term application of "work-around" systems and a longer-term centralized system solution. Fourth, effective partnerships were established between the CFO and IG organizations, in this case, even including negotiation of annual written agreements. Fifth, cooperation of nonfinancial managers was secured through persuasion and leveraging the commandant's commitment. Sixth, extraordinary effort was expended as seen in the employment of temporary teams of former Coast Guard personnel working to overcome problems in inventories, asset valuation, and historic cost. All of the elements of successful management strategies previously identified through interviews are observed in the Coast Guard case study.

## Department of the Army

The Department of the Army is one of three service components of the cabinet-level Department of Defense (DoD). The headquarters of the Department of the Army, located in the Pentagon, is responsible for assuring that the Army is resourced, trained, and equipped to meet its mission. Financial management in the Department of the Army is the responsibility of the assistant secretary of the Army (Financial Management and Comptroller). The ASA (FM&C), a Senate-confirmed presidential appointee, reports to secretary of the Army. (The author was assistant secretary of the Army [financial management], 1990-1993.) The assistant secretary is the *de facto* chief financial officer of the Army, but that title does not exist. Unlike some other Cabinet departments, the DoD has not created CFO positions within its reporting entities.

Historically, the Department of Defense has had a decentralized management structure wherein the military departments managed their own budget, finance and accounting systems, and financial operations. In the last decade, the department has moved to consolidate many of these activities. The consolidation of finance and accounting in the DoD was instituted to achieve greater efficiency and cost savings by reducing the redundancies of multiple systems serving similar functions in each of the services. One result is that the services no longer have control over the systems that generate their financial information. Now, the Defense Finance and Accounting Service (DFAS), a centralized accounting and finance entity created in 1991, performs most major accounting functions for the Army. While it appears that some efficiencies are being realized, the consolidation of financial management systems at the DoD level has affected the Army's strategic financial management decisions and its tactical capability to manage its financial statement processes.

The Department of the Army produces three financial statements. Each is subject to independent audit by the Army Audit Agency. These statements cover the Army general fund, the civil works component of the Army Corps of Engineers, and the Army working capital fund. For FY 1999, the general fund reported total assets of $72.2 billion, the civil works financial statement reported total assets of $39.6 billion, and the working capital fund had total assets of $13.9 billion.[33] This case study focuses mostly on Department of the Army efforts to produce reliable financial statements for the general fund, the largest of the three entities and the one that represents the broadest segment of the Army organization. The civil works financial statement, however, is the entity that auditors and financial managers expect will be the first in the Army to receive an unqualified opinion.

**Audit Opinions**

The Department of the Army was among the 10 pilot program agencies designated in the CFO Act to begin preparing business-style financial statements and subjecting them to independent audit. The Army prepared its first audited financial statement for FY 1991 and has been producing annual statements since then. The General Accounting Office audited the first two Army financial statements. Beginning with FY 1993, the Army's financial statements have been audited by the Army Audit Agency (AAA) under the oversight of the Department of Defense Inspector General (DODIG). The DODIG is statutorily responsible for the audit of the department-wide financial statements. All of the audits over this nine-year period have resulted in disclaimers.

On the first Army financial statement, the GAO reported material uncertainties about the amounts stated for most of the Army's assets and serious inadequacies in accounting systems. The GAO acknowledged that these results were not unexpected and credited the Army for initiating actions to address the problems. However, the GAO noted that "DoD has ongoing but longer range programs to improve accounting systems. Until the problems are corrected, Army will not have effective financial control nor will it have reliable information…."[34] The Army's second audit opinion from GAO produced a similar result. GAO disclaimed an opinion citing systems inadequacies, noncompliant record retention, and problems between Army and DoD policies on valuing military equipment.[35]

In FY 1993, the auditors changed from the GAO to the Army Audit Agency (AAA), but the disclaimers

[33] *Department of the Army,* United States Army, Annual Financial Report, Fiscal Year 1999, *(Washington: Department of the Army, 2000), 120, 209, 259.*

[34] *U.S. General Accounting Office,* Financial Audit: Examination of the Army's Financial Statements for Fiscal Year 1991, *(Washington: USGAO, 1992), 6-7.*

[35] *U.S. General Accounting Office,* Financial Audit: Examination of the Army's Financial Statements for Fiscal Year 1992, *(Washington: USGAO, 1993), 1-6.*

continued. The first audit by AAA cited systems problems: record retention problems, asset valuation problems, and understated liabilities for litigation, claims, and assessments. The future outlook was not encouraging to the new audit team. "The solution to many of the obstacles preventing us from expressing an opinion require joint efforts between all of the services and DoD—and will take years to complete."[36] The FY 1994 audit report added some new problems in the valuation of equipment on loan, awaiting repair, or held by contractors.[37]

The FY 1995 AAA audit reported many of the same problem areas, but it did, for the first time, include a section on "progress areas" that noted corrective actions that the Army had taken. In at least one area, munitions inventories, the controls were viewed as sufficient to ensure adequate reporting.[38] Further progress was reported in the FY 1996 audit, though problems with accounting systems, accounts payable, liabilities, and asset valuation continued to be cited as reasons for disclaiming an opinion.[39] The FY 1997 audit listed many of the same problems as reasons for another disclaimer but noted progress in 10 specific areas.[40] The FY 1998 and FY 1999 audits completed nine years of disclaimers for the Army.

**Management Strategies and Tactics**

In response to the disclaimer the Army received on its first financial statement, then-Secretary of the Army Michael P. W. Stone took an immediate and active interest in improving the Army's financial reporting. Stone had a background in business and was a former assistant secretary of the Army (financial management). He established a senior level steering committee to work on the issues reported in the audit and he "solicited assistance from private industry with the Private Sector Council (PSC) and Coopers and Lybrand."[41] Stone left office with the change of administration in January 1993, but some of the processes he put in place endured well past his term of office. The Private Sector Council continues to advise Army financial managers, and the Army's financial statement from FY 1995 indicates the existence of a senior level oversight group. It reports that a Senior Level Steering Group "chartered an effort to develop the Stewardship Improvement Plan, which was to be the Army's plan to enable it to better safeguard the Army's resources and also facilitate compliance with requirements of the [CFO] Act."[42]

The Private Sector Council established a task force of four senior financial managers from large private sector companies to advise the Army on its approach to preparing financial statements. The group was initially overwhelmed with the size and complexity of the Army organization, and it was troubled by the adversarial relationship it perceived to exist between Army and the GAO auditors. The task force also recognized that the Army did not have control over all of its finance and accounting. Nevertheless, at the recommendation of the PSC task force, corrective actions on matters under the Army's control were initiated and, as reported in the annual audits, some progress was steadily made in improving the financial management and reporting infrastructure.

However, with improvements in core finance and accounting systems resting with DFAS, the Army appears to have made a key strategic choice in favor of long-term systems improvement. It chose to rely on DFAS's long-term plan to replace the core financial systems for all of DoD. The alternative of developing its own short-term "work around" systems solution would have been too expensive for the Army in an era of declining budgets, and it would have been contrary to the strong movement toward centralization and consolidation within the Department of Defense. The Army, therefore, had to accept that a key ingredient for achieving a clean opinion was out of its control, though perhaps still somewhat within its sphere of influence. The AAA

[36] *Department of the Army,* Annual Financial Report, Fiscal Year 1993, *(Washington: Department of the Army, 1994), 93.*

[37] *Department of the Army,* Annual Financial Report, Fiscal Year 1994, *(Washington: Department of the Army, 1995), 79-80.*

[38] *Department of the Army,* Annual Financial Report, Fiscal Year 1995, *(Washington: Department of the Army, 1996), 91-92.*

[39] *Department of the Army,* Annual Financial Report, Fiscal Year 1996, *(Washington: Department of the Army, 1997), 103-106.*

[40] *Department of the Army,* Annual Financial Report, Fiscal Year 1997: Stewardship for an Army in Transformation, *(Washington: Department of the Army, 1998), 106-112.*

[41] *Department of the Army, "Message from the Secretary,"* Annual Financial Report, *September 30, 1992, (Washington: Department of the Army, 1993).*

[42] *Department of the Army,* Annual Financial Report, Fiscal Year 1995, *(Washington: Department of the Army, 1996), 92.*

apparently counseled and supported this strategy. "Solutions to many of these problems … require help from DoD and can't be solved quickly. There are, however, a number of problems that Army can resolve or mitigate on its own…. The Army should continue to concentrate on the problems open to unilateral solution."[43] Indeed, the department-wide systems solutions were far in the future. As late as March 1999, the CFO of the Department of Defense would write, "due to the size and scope of the systems efforts required, the department will not realize the full benefits of the ongoing systems initiatives for several years."[44]

With this long lead time and the lack of essential control over systems changes, the Army focused more on process improvements in financial management than on the goal of achieving an unqualified audit opinion. Indeed, the narrative in every financial statement between 1993 and 1997 refers to achieving "compliance with the CFO Act." Throughout these years, the Army claimed to be "aggressively implementing the CFO Act,"[45] asserting that "each successive audit has documented significant improvements in accounting controls, processes and systems,"[46] and boasting that "the Army … is now recognized as a leader in financial management reform in the Department of Defense.[47] ASA (FM&C) Helen McCoy described the Army's status this way, "Although we are still several years away from the reliable, integrated financial systems and processes required to achieve full compliance with the [CFO] Act, we strive continually to improve our processes and controls."[48] The strategic path chosen by the Army was to concentrate on the intent of the CFO Act and GMRA —improving agency financial management—rather than on achieving a clean opinion through the types of short term tactical approaches that smaller, more centralized agencies have successfully employed. Army Secretary Robert Walker described a broader process at work. "[CFO Act] implementation is a complex undertaking…. Clearly, developing auditable financial statements is a major objective in implementing the act, but the process improvements along the way are the true measures of our progress."[49] The FY 1998 Army financial report contains the first hint that the Army might be getting close to a clean opinion. Even then, however, the prize is obscured in the language of "compliance." Secretary Louis Caldera wrote, "I am confident that we will soon achieve full compliance with the [CFO] Act."[50] The FY 1999 financial statement contains the first expression of an unqualified opinion as a goal. Secretary Caldera wrote, "By striving to achieve an unqualified audit opinion, we improve the quality of the financial information we provide our leaders. Though we are not there yet, we have a plan in place that we are executing which will enable us to meet this requirement in the foreseeable future."[51] Assistant Secretary Helen McCoy was, at last, more direct. "Our Ultimate *[sic]* goal is an unqualified audit opinion on Army's financial statements…."[52]

If achieving a clean opinion is years away and not totally within Army's control, there must have been little incentive for the senior leaders to get involved in the process. As one senior Department of Defense official put it, "the goal of achieving a clean opinion has to appear to be achievable." If it is not, leadership interest, functional management cooperation, and positive resource allocation are not likely to be present. This appears to have been the case with Army between FY 1993 and FY 1998. Interviews with Army financial managers indicate little or no interest or support above the level of the ASA (FM&C), human and financial resources taken "out of hide" in an era of headquarters staff reductions and budget cuts, and resistance and disinterest among the functional communities who

[43] *Department of the Army,* Annual Financial Report, Fiscal Year 1994, *(Washington: Department of the Army, 1995), 81.*

[44] *Department of Defense, "Message from the Chief Financial Officer,"* Agency-Wide Annual Financial Statements: Fiscal Year 1998, *(Washington: Department of Defense, 1999).*

[45] *Department of the Army,* Annual Financial Report, Fiscal Year 1997: Stewardship for an Army in Transformation, *(Washington: Department of the Army, 1998), 5.*

[46] *Department of the Army,* Annual Financial Report, Fiscal Year 1996, *(Washington: Department of the Army, 1997), 41.*

[47] *Department of the Army, "Message from the Secretary of the Army,"* Annual Financial Report, *Fiscal Year 1995, (Washington: Department of the Army, 1996).*

[48] *Department of the Army,* Annual Financial Report, Fiscal Year 1997: Stewardship for an Army in Transformation, *(Washington: Department of the Army, 1998), 37.*

[49] *Department of the Army, Annual Financial Report, Fiscal Year 1997: Stewardship for an Army in Transformation, (Washington: Department of the Army, 1998), iii.*

[50] *Department of the Army, Annual Financial Report, Fiscal Year 1998: One Team, One Fight, One Future, (Washington: Department of the Army, 1999), iii.*

[51] *Department of the Army, Annual Financial Report, Fiscal Year 1999: Assuring Readiness for Today and Tomorrow, (Washington: Department of the Army, 2000), iii.*

[52] *Department of the Army, Annual Financial Report, Fiscal Year 1999: Assuring Readiness for Today and Tomorrow, (Washington: Department of the Army, 2000), v.*

controlled vital systems and information. The job of preparing financial statements and making progress in "implementing" the CFO Act seems to have been left to the office of the deputy assistant secretary (financial operations).

As was seen in the case study of the Department of Veterans Affairs, a perceptible change occurred at DoD in 1998. Perhaps the change at Defense was also as a result of the president's letter to heads of agencies. Whatever the motivation, there was a change in the level of interest and involvement by the department's top leadership in 1998. The secretary of defense signed the first Financial Management Improvement Plan, sending a clear signal to the service secretaries of top-level interest. It was followed by regular meetings of the Defense Management Council chaired by the deputy secretary of defense and including the service under secretaries. John Hamre, the deputy secretary, was a former CFO of the DoD, and the focus of these sessions was on the financial statements.

Within the Army, the leadership still had not provided any additional funding in the budget to pay for the effort of producing clean financial statements. However, beginning in FY 1998, the Army Budget Office was able to make a modest reallocation of funds to support a more aggressive approach to CFO Act requirements. This funding was used to procure contractor support to develop a "CFO Strategic Plan." Assistant Secretary McCoy explained, "In FY 1998 we published our roadmap for the next five years. A management plan often used in the private sector, the Chief Financial Officers Strategic Plan will steer the integration and improvement of Army financial management into the 21st century."[53] The plan originally identified 247 separate tasks that had to be accomplished in order to get a clean opinion. In the first year of operations under the plan, 100 tasks were completed, and another 70 were added.[54]

The strategic plan has been instrumental in drawing functional and operational managers into the process of improving financial information. "By executing this plan we will be able to place reliable information in the hands of commanders and leaders at every level of the Army."[55] A leader of the Army's financial operations observes that the strategic plan has facilitated cooperative arrangements with logistics and personnel managers who now see value from integrating their systems with the financial systems. Development of the CFO Strategic Plan also has had the effect of drawing the auditors and financial managers into closer cooperation. The Army Audit Agency helped to develop the overall framework, based on prior audit findings, and after the first year, the AAA was invited to assess the plan and make recommendations for improvements. The auditors now participate in quarterly in-progress review meetings and in weekly staff briefings.

This close cooperation was not always the case in the Army. Earlier relations between the AAA and the financial management office were quite contentious, perhaps as a legacy of the difficult relationship that had existed with the GAO auditors. For its part, the AAA had to develop new audit capabilities as it came to recognize that the corporate financial audit model was different from the performance and program audits that were its traditional audit models. At the same time, the AAA also found that sectoral differences limited the application of private sector audit models—risks are not the same in the public and private sectors, for instance, nor are materiality thresholds.

Auditors and leading financial managers both report that a positive collaborative relationship now exists. As one audit leader explained, "We would like to be further along. Our objective is to get [Army] to a clean opinion." In fact, the improvement in audit relationships is documented in the AAA customer satisfaction reports. Satisfaction ratings, on a five-point scale, are based on questionnaires that measure such dimensions as satisfaction with the audit process, satisfaction with audit teams, timing, and subject matter issues. The recent ratings are quite high. The AAA reports that overall customer satisfaction ratings for Army general fund audits improved from 4.18 in FY 1997, to 4.20 in FY 1998, and 4.36 in FY 1999.[56]

Where does the Army stand now, in early 2001, in its quest for a clean audit opinion? The Army's

[53] *Department of the Army,* Annual Financial Report, Fiscal Year 1998: One Team, One Fight, One Future, *(Washington: Department of the Army, 1999), 43.*

[54] *Department of the Army,* Annual Financial Report, Fiscal Year 1999: Assuring Readiness for Today and Tomorrow, *(Washington: Department of the Army, 2000), 4-5.*

[55] *Department of the Army,* Annual Financial Report, Fiscal Year 1998: One Team, One Fight, One Future, *(Washington: Department of the Army, 1999), 52.*

[56] *Army Audit Agency, internal reports,* Customer Satisfaction With Products Issued by FFG/FAF, FY '99,FY '98 and FY '97.

stated goal is to achieve an unqualified opinion by FY 2003.[57] The Army is still very dependent upon systems improvements that rest with the DoD and DFAS to accomplish. Nevertheless, the Army does now seem to have in place some of the major elements of successful management strategies. Some modest positive resource allocation is available, partnerships have been established between financial managers and the auditors, and cooperation with functional managers is being achieved. Early strategic decisions rejected application of short-term systems solutions or extraordinary manual effort as being inapplicable in such a large and complex organization. There remains a question about the extent of the interest and involvement of the senior leaders of the Army.

## Department of Education

The Department of Education was established as a Cabinet department in 1979 but traces its organizational roots in the federal government back to 1867. It defines its mission as being "to ensure equal access to education and to promote educational excellence throughout the nation."[58] These responsibilities are administered through eight program offices: Student Financial Assistance, Elementary and Secondary Education, Education Research and Improvement, Vocational and Adult Education, Postsecondary Education, Bilingual Education and Minority Language Affairs, Special Education and Rehabilitative Services, and the Office of Civil Rights.[59] The Department of Education has 4,810 employees. It had fiscal year '96 budget outlays totaling $29.7 billion, and its total entity assets reported in fiscal year 1998 amounted to $88 billion. The department manages a complex mix of some 230 appropriations and relies heavily on cross-servicing, contractor services, and participants in its loan guarantee programs to carry out its mission. These sources also perform financial transactions for the department.

### Audit Opinions

An illustrative look at the Department of Education presents a picture of a department with a complex audit history. The department suffered a disclaimer from the auditors on its FY 1996 financial statement. In fact, it published its FY 1996 *Accountability Report* with an unaudited financial statement because the audit was still underway. The *Report* noted, however, that the department had received a disclaimer on its FY 1995 financial statement.[60] The FY 1997 financial statement was three months late but it achieved a clean opinion. Education had vaulted from a disclaimer all the way to a clean opinion, the only agency in the four years to achieve that degree of improvement in one year. However, the auditors' report indicates some cautionary notes. They cite the use of significant estimates related to the student loan programs and note that uncertainties inherent in the estimates could result in material changes to the financial statements. The auditors also cited the use of two parallel estimating techniques for other loan programs and loan guarantees.[61] The department fell to another disclaimer on the FY 1998 financial statement. The department's contract auditors cited inadequate reconciliations and documentation, but placed most of the blame on the inability of a new accounting system to perform the year-end closing process or produce automated consolidated financial statements.[62] The disastrous FY 1998 audit report was followed by a qualified opinion on the fiscal 1999 financial statement. The auditors noted the department's efforts to conduct manual adjustments to its records, but issued a qualified opinion stating that the statements presented fairly Education's financial position except for issues concerning adjustments to the balance sheet and related statements of net cost and changes in net position.

### Management Strategies and Tactics

What management strategies and tactics drove Education all the way from a disclaimer to a clean opinion in the span of one year? What key decisions resulted in the fall back in 1998? Based on this experience, what strategies are being employed now to manage the long climb back to a clean opinion?

[57] *Department of the Army,* Annual Financial Report, Fiscal Year 1999: Assuring Readiness for Today and Tomorrow, *(Washington: Department of the Army, 2000), 5.*

[58] *U.S. Department of Education, Annual Accountability Report: Fiscal Year 1999, (Washington, Department of Education, 2000), 2.*

[59] *Ibid., 1.*

[60] *U.S. Department of Education, Annual Accountability Report: Fiscal Year 1996, (Washington: Department of Education, 1997), ii.*

[61] *U.S. Department of Education, "Opinion on Consolidated Financial Statements,"* Annual Accountability Report: Fiscal Year 1997, *(Washington: Department of Education, 1998), 1.*

[62] *U. S. Department of Education, "Report of Independent Auditors,"* Annual Accountability Report: Fiscal Year 1998, *(Washington: Department of Education, 1999), 1.*

In preparing the FY 1997 financial statement, a focused effort was made to cross the materiality threshold for a clean opinion using two familiar tactics—massive human resource effort and spreadsheets to work around systems deficiencies and internal control weaknesses. This extraordinary effort and use of work-around systems delayed the financial statement by three months. But the auditors were eventually satisfied that Education had it achieved reliability above the required level of materiality.

However, the department knew that it had to improve its automated core financial systems. It could not sustain clean opinions throughout the following years with a strategy based on heroic effort and spreadsheets. A plan was implemented to move rapidly toward a client-server systems architecture, replacing the old mainframe computer. Commercial off-the-shelf software applications were available that seemed to offer a quick solution. Many were self-certified, (other agencies having already done the "due diligence" tests required), and some were even on the GSA purchasing schedule. The conversion plan was to cut over to the new system in midyear. This meant that the department would be dealing with partial-year data on the new system before starting the next new fiscal year. A "work-around" system would be needed at least for purposes of charging transactions to the right fiscal year. But conversion problems arose, and the accounting systems could not do reconciliations or the required year-end close-out. An attempt to do trial balances by appropriations and then transfer this data into five financial statements resulted in over 1,000 spreadsheets. Strains also were developing between auditors who were becoming frustrated with the inadequacies of the financial information and the financial managers who were pushing to get the audit completed. Finally the decision was reached to shut down this effort, accept a disclaimer for FY 1998, and start working toward improvement for FY 1999. CFO Thomas P. Skelly explained, "Due to time and resource constraints, we redirected the efforts required to support the delayed FY 1998 audit into preparing for the FY 1999 audit cycle."[63]

Planning for FY 1999 not only meant starting over with a more comprehensive plan, but doing so with increased scrutiny from Congress and greater participation by the department's senior leadership. Driven by the deputy secretary, fixing the financial reporting systems was made a department-wide priority and, again, an extraordinary manpower effort was applied in December 1998 to research and process financial records. Resources were shifted from other, lower priority activities, and a fundamental strategic shift was adopted. Instead of focusing on the immediate requirements of the financial statement, the department adopted what seemed to be the opposite of its former strategy. Henceforth, the plan would focus on improving internal controls, believing that by doing so, a sustainable clean opinion would follow. The department achieved a qualified opinion for FY 1999 but, as one senior financial official put it, "the road back to credibility is a long one."

[63] *U. S. Department of Education, "Message from the Chief Financial Officer,"* Annual Accountability Report: Fiscal Year 1998, *(Washington: Department of Education, 1999), i.*

# Study Findings

As the case studies indicate, the task of achieving and sustaining clean audit opinions often involves overcoming obstacles to success. These can be organizational obstacles, reflecting the size, complexity, operations, or geography of the agency. Or, they can be management obstacles, reflecting the culture, leadership, professional capabilities, and interpersonal relationships involved in the management of an agency. But the research also shows that these inhibiting factors are hurdles rather than barriers. They are obstacles that can be overcome to achieve success, rather than being factors that necessarily prevent success. The findings of this research, therefore, suggest some areas where agency leaders and financial managers can measure the policies and practices of their own organizations to see if changes in organizational factors or management strategies are needed to get and keep clean audit opinions.

## Organizational Factors

Organizational characteristics that might affect the ability of an agency to achieve clean audit opinions can be of two types. The first would be characteristics of the agency as a whole, such as size, geographic dispersion, and organizational complexity. And, indeed, some research has shown the expected correlations between these variables and the frequency and distribution of clean audit opinions.[64] But these factors are essentially out of the control of agency financial managers. They are relatively fixed conditions within which managers must operate. A second set of organizational characteristics pertains specifically to the financial management organization of an agency. These characteristics, presumably, are more within the financial managers' control, or at least can be influenced to support the effort to achieve clean audit opinions. This research considered three such characteristics: the number of financial management systems, the number of reporting entities, and the duties of the chief financial officer.

**Finding #1. Agencies with the most financial management systems have the fewest clean audit opinions.**

The financial systems employed by each agency range from seven in the Department of Energy to 144 in the Department of Agriculture.[65] Figure 1 displays the 96 audit opinions by the number of agency financial management systems.

The numbers of systems are collapsed into four groups. The per-agency rates of unqualified audit opinions vary with the number of financial management systems, but not exactly. Agencies with fewer than 25 systems achieved 2.5 clean opinions per agency. Those with between 26 and 50 systems had 1.6 clean opinions per agency. Agencies with 51-75 systems had 2.0 clean opinions per agency, and the four agencies with over 76 systems had only one clean audit opinion. Not all of the agencies that

[64] *Douglas A. Brook,* Business-Style Financial Statements Under the CFO Act: An Examination of Audit Opinions, *(Ann Arbor: University Microfilms, 2001).*

[65] *Executive Office of the President, Office of Management and Budget,* Federal Financial Management Status Report and Five Year Plan, *(Washington: OMB, June, 1999), 26.*

**Figure 1: FY 1996-99 Agency Audit Opinions by Number of Financial Management (FM) Systems**

| Audit Opinions | Number of FM Systems 1-25 | 26-50 | 51-75 | 76+ |
|---|---|---|---|---|
| Unqualified ("Clean") | 25 | 8 | 10 | 1 |
| Qualified | 7 | 2 | 6 | 5 |
| Disclaimed | 8 | 10 | 4 | 10 |
| Number of Agencies = | 10 | 5 | 5 | 4 |
| "Clean" Audit Opinions Per Agency = | 2.5 | 1.6 | 2.0 | .25 |

did not achieve clean audit opinions between FY '96 and FY '99 are in the largest categories, however. The USDA (144), Defense (107), and Treasury (99) departments are among those with the most financial management systems, of course. But Justice (49), the Agency for International Development (32), and the Office of Personnel Management (8) also failed to achieve clean opinions during this four-year period, despite the fact that they have fewer systems than some agencies that have successfully achieved clean opinions. Nevertheless, overall, it appears that the number of separate financial systems has a relationship to the achievement of unqualified audit opinions.

**Finding #2. Agencies with the most reporting entities have the fewest clean audit opinions.** Reporting entities are subunits within the agencies that prepare their own financial statements. In some agencies, the reporting entities conform to their major operational organizations, while in others, the reporting entities are even more discreetly defined financial entities. The CFO Act does not require audits of reporting entity financial statements but many agencies do, in fact, subject the statements of their reporting entities to independent audit. These statements are then consolidated into the agency-wide financial statement.

As with the number of financial systems, the number of reporting entities is an implicit measure of the complexity of an agency's financial management organization. The number of reporting entities ranges from one (essentially the agency itself), for five of the Cabinet agencies and six of the independent agencies, to 26 in the Department of Defense.[66] The distribution of audit opinions by the number of reporting entities is shown in Figure 2.

The number of reporting entities is collapsed into three groups. The frequency of unqualified audit opinions varies with the number of reporting entities. Agencies with five or fewer reporting entities achieved 2.4 clean audit opinions per agency. Agencies with 6-10 reporting entities had 1.2 clean audit opinions per agency. Those with 11 or more reporting entities had 0.5 clean opinions per agency. There are variations within the categories, however, that indicate that the variability is not exact. Considering just the agencies that have never achieved a clean opinion between FY '96 and FY '99, there are the larger agencies like Defense (26 reporting entities) and Treasury (20), of course. But the list also includes the USDA and AID with seven reporting entities each, OPM (5), and the Department of Justice (1). Generally, however, the record of unqualified opinions appears to be related to the number of reporting entities.

**Figure 2: FY 1996-99 Agency Audit Opinions by Number of Agency Reporting Entities**

| Audit Opinions | Number of Reporting Entities 1-5 | 6-10 | 11+ |
|---|---|---|---|
| Unqualified ("Clean") | 36 | 6 | 2 |
| Qualified | 11 | 4 | 5 |
| Disclaimed | 9 | 14 | 9 |
| Number of Agencies = | 15 | 5 | 4 |
| "Clean" Audit Opinions Per Agency = | 2.4 | 1.2 | 0.5 |

[66] *Source: Agency* Financial Statements, Accountability Reports *and Websites.*

**Finding #3. CFOs with oversight of core financial management functions have more clean opinions than other CFOs. CFOs with "distracting" functions have fewer clean opinions than other CFOs.** Two issues are involved in considering the duties and responsibilities assigned to the CFO and the relationship of these assignments to the preparation of reliable financial statements. First is the assertion that CFOs must have authority over the three core financial management functions—budget formulation and execution, financial operations and analysis, and financial systems—in order to perform their duties and meet their responsibilities under the CFO Act. On the other hand, it is also asserted that CFOs should not have additional responsibilities that distract them from financial management. Some CFOs have substantial additional duties, including agency-wide information resource management, personnel, procurement, grants management, and agency administration. These significant responsibilities could serve to create competing priorities for the time, attention, and leadership of the CFO.

Figure 3 shows the distribution of audit opinions based on whether or not the CFO has authority over the three core financial management functions.

Nineteen CFOs have all three core functions in their portfolios, five do not.[67] The rate of unqualified opinions per agency for those with core CFO responsibilities is 2.0. CFOs without all three core functions have achieved 1.2 unqualified audits per agency. Figure 4 shows that 14 CFOs have "distracting" responsibilities and 10 do not.[68]

**Figure 3: FY 1996-99 Agency Audit Opinions by Core Financial Management (FM) Functions in CFO Office**

| Audit Opinions | With Core FM Functions | Without Core FM Functions |
|---|---|---|
| Unqualified ("Clean") | 38 | 6 |
| Qualified | 16 | 4 |
| Disclaimed | 22 | 10 |
| Number of Agencies = | 19 | 5 |
| "Clean" Audit Opinions Per Agency = | 2.0 | 1.2 |

Those with distracting responsibilities also had only 1.2 unqualified audit opinions per agency. Those whose functions do not go beyond financial management have a much higher success rate, with 2.7 unqualified opinions per agency. There are four CFOs who have the worst potential combination of duties, i.e., they do not have authority over all core financial functions and they also have nonfinancial responsibilities. Collectively, these four agencies have only three clean opinions out of a possible 16, and two have four straight disclaimed opinions. There is a clear correlation between the duties of the CFO and the achievement of clean audit opinions.

**Figure 4: FY 1996-99 Agency Audit Opinions by CFO "Distracting" Functions**

| Audit Opinions | With Distracting Functions | Without Distracting Functions |
|---|---|---|
| Unqualified ("Clean") | 17 | 27 |
| Qualified | 15 | 5 |
| Disclaimed | 25 | 7 |
| Number of Agencies = | 14 | 10 |
| "Clean" Audit Opinions Per Agency = | 1.2 | 2.7 |

## Management Strategies

What management strategies and tactics have successful agencies employed to produce financial statements that earned clean audit opinions? What management benchmarks can be applied to deter

[67] *Executive Office of the President, Office of Management and Budget,* Federal Financial Management Status Report and Five Year Plan, *(Washington: OMB, June, 1999), 59.*

[68] *Executive Office of the President, Office of Management and Budget,* Federal Financial Management Status Report and Five Year Plan, *(Washington: OMB, June, 1996), 26.*

mine whether an agency is on the right track toward producing reliable financial statements? Certain common themes on these questions emerge from interviews with chief financial officers, deputy CFOs, inspectors general audit staffs, and other senior financial managers in 15 of the 24 CFO Act agencies.

Four broad strategies are identified in the most successful agency efforts to achieve clean audit opinions. They are: (1) commitment and involvement by senior agency leaders, (2) positive allocation of human and financial resources to the task of producing reliable financial statements, (3) collaborative arrangements or partnerships between financial managers and the inspector general's financial auditors, and (4) establishing cooperative support from operating entities and other nonfinancial managers. To greater or lesser degrees, these strategies emerge in discussions with almost all of the financial managers in agencies that have achieved clean opinions. On the other hand, in interviews with financial managers whose agencies have not yet reached a clean opinion, it is clear that one or more of these strategies is missing.

In addition to these broad strategies, it appears that successful agencies have often taken two tactical approaches to dealing with the challenge of overcoming shortcomings in the information produced by existing financial systems: (1) short-term "work-around" systems solutions, and (2) employing extraordinary effort to generate reliable financial information. On the technical issues of accounting and reporting financial information, all but two or three of the CFO Act agencies were confronted with major challenges posed by financial management systems and practices that were not designed to produce information for agency-wide financial statements. Failure to overcome these deficiencies accounts for failure to achieve clean audit opinions. "[S]ignificant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation … continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. These deficiencies affect the reliability of the financial statements…."[69] These challenges were common to most agencies, yet some agencies have overcome them and gone on to achieve unqualified audit opinions on their financial statements.

Most agencies had to develop long-term plans for fixing their existing systems, developing centralized or integrated financial systems that link financial information with logistics, operating, and budgetary information requirements. But the time, expense, and effort involved in such a large undertaking often meant that waiting for new systems to come on line would delay the achievement of reliable financial information and progress toward clean audit opinions. An alternative, short-term approach was adopted by some agencies to provide an interim solution to the task of producing reliable information for the financial statements. In some cases, these were separate information systems that fed the requirements of the financial statements, without necessarily linking the information to other agency needs. A second, complementary approach was to apply extraordinary amounts of personnel and money into manually overcoming the deficiencies of current information shortcomings. Both of these approaches had benefits and limitations and each, used solely, was not always successful. In combination, however, they seem to have formed a successful short-term solution in the effort to achieve a clean opinion.

**Finding #4. Agencies with demonstrated senior leadership commitment have achieved more clean audit opinions.**

The commitment and leadership of senior agency officials was regularly identified in interviews as perhaps the single, most important management factor in the drive for clean audit opinions. As shown in Figure 5, agencies where senior leadership commitment and involvement was identified as an element of their strategies had an unqualified opinion rate of 2.86 per agency and a disclaimed opinion rate of 0.43 per agency. On the other hand, agencies where leadership commitment was not reported to be present had only a 0.83 per agency rate of unqualified opinions and a 2.67 per agency rate of disclaimers.

What is meant by senior leadership commitment and how is the involvement of an agency's top brass manifested in day-to-day operations? Agency

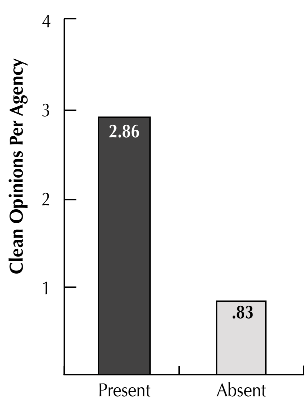
[69] *U.S. General Accounting Office,* Financial Audit: 1998 Financial Report of the United States Government, *(Washington: GAO, March, 1999), 1.*

**Figure 5: FY 1996-99 Audit Opinion by Presence of Key Management Strategies and Tactics**

| | Leadership Commitment | | | Positive Resource Allocation | | | Partnering With IG | | | Cooperation of Non-Financial Managers | | | Short-Term Systems | | | Extraordinary Effort | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | U | Q | D | U | Q | D | U | Q | D | U | Q | D | U | Q | D | U | Q | D |
| | 20 | 5 | 3 | 23 | 7 | 14 | 27 | 8 | 9 | 21 | 6 | 5 | 10 | 3 | 3 | 12 | 6 | 2 |
| Presence of Factor-YES | U = 2.86<br>D = 0.43<br>n = 7 | | | U = 2.09<br>D = 1.27<br>n = 11 | | | U = 2.45<br>D = 0.82<br>n = 11 | | | U = 2.63<br>D = 0.63<br>n = 8 | | | U = 2.75<br>D = 0.75<br>n = 4 | | | U = 2.4<br>D = 0.4<br>n = 5 | | |
| | U | Q | D | U | Q | D | U | Q | D | U | Q | D | U | Q | D | U | Q | D |
| | 5 | 3 | 16 | 4 | 0 | 8 | 0 | 0 | 12 | 0 | 0 | 8 | 3 | 3 | 14 | 3 | 0 | 3 |
| Presence of Factor-NO | U = 0.83<br>D = 2.67<br>n = 6 | | | U = 1.33<br>D = 2.67<br>n = 3 | | | U = 0<br>D = 4.0<br>n = 3 | | | U = 0<br>D = 4.0<br>n = 2 | | | U = 0.6<br>D = 2.8<br>n = 5 | | | U = 0.75<br>D = 3.25<br>n = 4 | | |

U = Unqualified ("Clean") opinion
Q = Qualified opinion
D = Disclaimed opinion
n = Number of observations

**Chart 1: Leadership Commitment**




leaders—secretaries, deputy secretaries, directors and administrators—generally must choose their priorities from a variety of competing demands. Agency leaders who decide that producing a reliable audited financial statement is an important organizational priority can direct resources and energy into that area and hold managers accountable for addressing the issue. That is exactly what is seen in the interviews with agency financial managers. Managers in agencies with clean opinions cite the commitment and involvement of top leadership. They point to internal correspondence and public statements made by the agency's leaders; they cite personal involvement by senior officials in demanding periodic reports and briefings; they indicate that personnel and resource decisions were made to support the effort to produce financial statements; and they give examples of agency leaders who mediated internal organizational disputes in a way that empowered the CFO's organization and compelled cooperation by other entities within the agency.

Conversely, interviews with financial managers who have not yet achieved clean opinions cite periods of leadership neglect. "Our secretary was slow to recognize this [audited financial statements] as a priority," said one frustrated deputy CFO. Other interviewees simply do not mention the interest or involvement of their top leadership, at all, and others point to a changed situation when the person at the top changed. "I never saw any sign of interest from our former secretary," said one deputy CFO. "Our CFO just didn't have a seat at the [secretary's] table." A number of managers cited the President's letter of May 26, 1998, as an important milestone in agency leaders' interest in financial statements. In this letter to heads of executive departments and agencies, President Clinton directed agency heads to prepare a plan for resolving financial reporting deficiencies and submit this plan to OMB within two months. Further it directed agency heads to submit quarterly progress reports to OMB.[70] Clearly, the White House saw the need for agency leadership involvement and sought to put in place a program where agency heads could no longer avoid personal cognizance and responsibility over financial reporting. But even this was not decisive across the board. One CFO in an agency that has never gotten a clean opinion portrayed his boss' attitude as being resigned to criticism on the audit front. Instead, he chose to concentrate on other high profile issues in the department that had a better probability of success within the short time of his tenure in office. Another with a string of disclaimed audits said there were no consequences felt by the agency's leaders, no pressure from oversight committees on Capitol Hill or even from OMB. These were the unusual cases, however. More often, OMB pressure, Capitol Hill interest, and bad publicity were cited as motivations for greater senior level involvement.

**Finding #5. Agencies that made positive resource allocations to the effort have achieved more clean audit opinions.**

Any new administrative requirement means that resources have to be assigned to it, if it is to be addressed. Seldom, if ever, do administrative reforms come with new funds appropriated directly to their implementation. Instead, money and people have to be found within the agency's resources to address the new requirement. The requirement for audited financial statements generated a considerable demand for resources, both human and financial. Funds were required for systems upgrades, contractor support, and audit training, for example. People were required to do everything from manage the production of financial statements to counting inventories in remote warehouses. These resource demands coincided with a period of restraint in the growth of federal spending, and the streamlining and downsizing associated with the movement to "reinvent" the federal government. Resource allocation for audited financial statements, therefore, has had two components: the positive application of personnel and money, and insulating financial management from the effects of downsizing and resource constraints.

Some agencies with successful audit histories show tangible evidence of internal reprogramming of financial resources to allow for new or accelerated systems development or for procuring contractor assistance. Others pointed to business process improvements that permitted the reassignment of people from lower priority duties to work on the financial statements. Many found the money to retain private sector accounting and consulting firms to assist in producing the financial statement and attacking problem areas. These special allocations of resources often took place in both the financial management and the audit organizations. Inspectors general often had to reassign people and money to meet their new obligations under the CFO Act. Two CFOs reported that they "taxed" the budgets of their bureaus and operating entities to pay for both the CFO's financial statements and the IG's audits. One CFO actually paid out of his own appropriation for the IG's contract with an outside audit firm, after checking with legal and congressional staffs that this would not amount to an improper augmentation of the inspector general's appropriation.

Complaints about resourcing are more often heard in interviews with financial managers whose organizations still do not have clean audit opinions. As one financial manager put it, "We haven't been told to stop doing anything else. Whatever we do on financial statements we have to 'take out of hide'." Another, whose finance organization had been hit by across-the-board downsizing, said that the CFO Act, GMRA, and the other management reforms of the '90s combined to increase his responsibilities and decrease his resources simultaneously. Figure 5 shows that interviews with senior agency financial managers who said their agency was able to make positive internal resource allocations had an unqualified opinion rate of 2.09 per agency and a disclaimed opinion rate of 1.27 per agency. By contrast, agencies that did not identify

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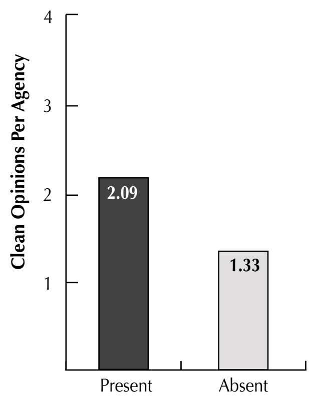
[70] *William J. Clinton, "Actions to Improve Financial Management,"* Memorandum for the Heads of Executive Departments and Agencies, *May 26, 1998.*

positive resource allocations had only a 1.33 per-agency rate of unqualified opinions and a 2.67 per-agency rate of disclaimers.

**Chart 2: Positive Resource Allocation**



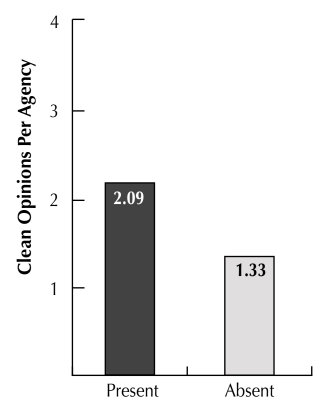

**Finding #6. Agencies with positive working partnerships between financial managers and auditors have achieved more clean audit opinions.**

Many of the managers that were interviewed for this research commented on the relationship between financial managers and inspectors general auditors. Clearly, prior relationships had the potential for affecting the way the financial managers and their IG auditors approached each other and this new assignment. Some financial managers expressed concern that IG staffs, with their prior emphasis on program audits, were locked into an adversarial "gotcha" mentality, focused on finding and reporting problems. In a few cases, there may have been quite serious histories of distrust between financial managers and their auditors. In three cases, the relationships were so bad that the IG-CFO relationship improved only after a change in the person who held one or both of these positions. One financial manager whose agency has not achieved a clean opinion observed that his IG's "program audit mentality" made it difficult to agree on materiality. To the IG, he asserted, any weakness results in a "gig" regardless of its financial materiality. Another was even more direct: "When we got a new IG, we got a clean opinion."

Some inspectors general, themselves, were concerned. Though they were experienced in program audits—exposing fraud, waste, abuse, and mismanagement—they were unprepared to undertake financial audits without additional training and/or hiring new auditors with private sector auditing experience.

Other financial managers referred to "partnering" with the audit staff. These collaborative arrangements were characterized by such practices as joint meetings throughout the year, cooperative approaches to defining problems and proposing solutions, interim reviews or "mini-audits," and negotiated agreements. Fewer officials in agencies without clean audit opinions cite a positive relationship with their auditors as an active management strategy, and some complain about their relationship with or the capabilities of their auditors. As shown in Figure 5, senior agency financial managers who claim to have established a collaborative relationship with their IG auditors had an unqualified opinion rate of 2.45 per agency and a disclaimed opinion rate of 0.82 per agency. On the other hand, agencies where such partnerships were not reported to be present had no unqualified opinions and a 4.0 per agency rate of disclaimers.

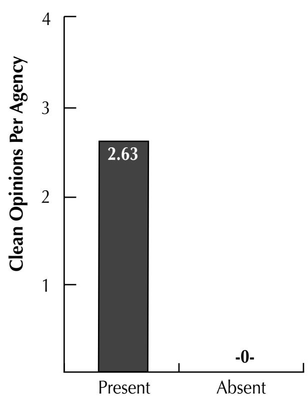
**Chart 3: Partnering with IG**




**Finding #7. Agencies with positive cooperative arrangements between financial and line and functional managers have achieved more clean audit opinions.**

One department logistician was quoted by a financial manager as saying, "With my systems and procedures, I can procure, receive, store, ship, bill, and pay for the equipment my [operating entities] need. I see no benefit to my mission for the added costs and burdens of financial reporting." Yet to meet his financial reporting requirement, this financial manager was going to have to count and place a value on everything in that logistician's warehouses. Cooperation between the CFO's organization and nonfinancial managers throughout the agency is often cited as a factor in achieving the reliable reporting needed to produce good financial statements. As shown in Figure 5, agencies whose financial managers reported that they had overcome problems with nonfinancial managers and secured the cooperation of operating and program managers had an unqualified opinion rate of 2.63 per agency and a disclaimed opinion rate of 0.63 per agency. On the other hand, agencies with persistent problems with nonfinancial managers had no unqualified opinions and a 4.0 per-agency rate of disclaimers.

**Chart 4: Cooperation of Nonfinancial Managers**




In some cases, financial managers claim to have achieved cooperation through personal relationships and through efforts to convince nonfinancial managers of the value of financial reporting or the importance of the requirement. In other cases, CFO staffs have admitted to inducing cooperation through senior level directives or exercising their leverage over budgets and resource allocation decisions. Joint working groups are frequently mentioned as a tactic used to coordinate with operational and program managers. Some agencies, like the Department of Commerce, created CFO positions in their operating bureaus at the Senior Executive Service (SES) level. Recognition programs for both financial staff and nonfinancial managers were also employed by some agencies. The Coast Guard awarded over 100 civilian and military awards when it achieved a clean opinion. The Commerce Department held a special recognition ceremony and awarded gold and silver medals to department personnel.

Financial managers in some agencies, however, admit to not yet having overcome the disinterest, resistance, or lack of cooperation by nonfinancial managers. "You have to convince them that it's in their best interests," lamented one financial official without a clean opinion. "It's not like the private sector where the usefulness [of financial statements] is understood."

**Finding #8. Many agencies achieved clean opinions by employing short-term "work-around" systems solutions.**

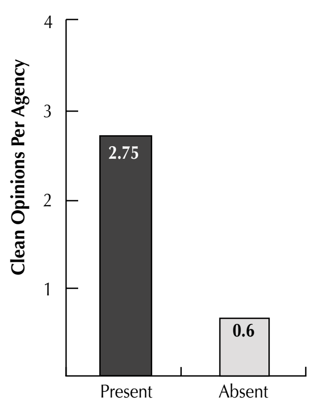
CFOs in three agencies reported that they had single, centralized accounting systems that were either capable of producing reliable financial information or which could be readily adapted to meet the requirements of consolidated financial statements. For most, however, overcoming systems deficiencies was a common hurdle in the pursuit of clean audit opinions. Agency leaders had a fundamental tactical choice to make. They could decide to invest in fixing and integrating their core accounting systems so that agency-wide financial data could be produced. Or, they could choose, at least for the short term, to build a separate financial information system that serves only the information needs of financial statements. Some financial managers believe that it is difficult to get and sustain clean opinions outside of integrated systems. These managers have concentrated on systems improvement programs that not only produce reliable financial information, but also support budget, logistics, and other information management needs. They seek to achieve broader, integrated, long-term goals: producing reliable financial statements, reducing their material weakness in internal control, and complying with the requirements of the Federal Financial Management Integrity Act (FFMIA), through massive systems upgrades.

Certainly, this should be a long-range goal for every agency. Whether an agency selects this tactic or not may depend upon some organizational factors. A large, highly complex agency with a great number of legacy systems might find that this is not a good short-term strategy. On the other hand, smaller, less complex agencies, which can provide the resources, have strong leadership commitment, and have the support of nonfinancial managers, may be able to push through agency-wide resystemization and produce reliable financial statements within a relatively short period of time.

But, for many CFOs, rebuilding the agency-wide information technology infrastructure would be too expensive and too time-consuming to meet their immediate requirement to produce audited, reliable financial information. Instead, they built alternative, supplemental, or "work-around" systems to produce information for the financial statement, without necessarily being linked to other financial, budget, logistics, or operating entity systems. Two agencies that took this approach reported that they created "huge Excel spreadsheets" to collect and process data for the financial statements outside of their core financial systems.

As shown in Figure 5, senior agency financial managers who reported that they adopted short-term "work-around" systems to meet the immediate requirements of the financial statements had an unqualified opinion rate of 2.75 per agency and a disclaimed opinion rate of 0.75 per agency. On the other hand, agencies where short-term strategies were not employed had only a 0.6 per-agency rate of unqualified opinions and a disclaimer rate of 2.8.

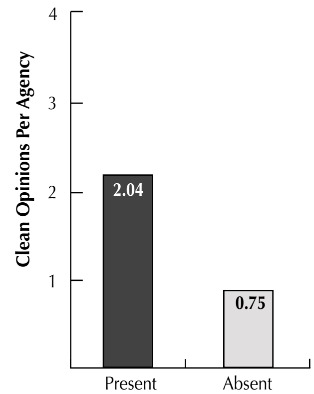
**Chart 5: Short-Term Systems**




**Finding #9. Many agencies achieved clean audit opinions by applying extraordinary effort to key problem areas.**

Finally, it is possible to try to achieve a clean opinion by simply applying extraordinary effort over a short period of time. This approach was employed in a number of agencies and, as shown in Figure 5, the effort seems to have produced positive results. Agencies whose senior financial managers said they applied extraordinary effort had an unqualified opinion rate of 2.4 per agency, and a disclaimed opinion rate of 0.4 per agency. On the other hand, agencies that did not make an extraordinary effort had only a 0.75 per-agency rate of unqualified opinions and 3.25 disclaimers per agency.

**Chart 6: Extraordinary Effort**




Extraordinary effort usually meant the employment of large numbers of personnel to accomplish tasks that the current systems and procedures cannot manage. One agency with a string of unqualified opinions reported that they assigned people and hired a small private sector accounting firm to work at the agency's finance center in a two-year effort to generate reliable data. Other examples include assigning task forces of extra people to count inventories, research acquisition histories, or enter data. Money was also spent by many agencies on contractor assistance and commercial off-the-shelf software to build "work-around" systems and manage financial data.

"Heroic effort" alone is not enough. Some agencies made heroic efforts and still failed to reach a clean opinion because they remain saddled with inadequate financial systems and other problems. Others found "heroic effort" to be expensive and difficult to sustain. Gaining a clean opinion, year after year, through extraordinary effort may not be possible.

# Recommendations

Clean audit opinions have been achieved more often by agencies with fewer institutional impediments. Consideration must be given to institutional factors, such as those addressed in this study, in setting goals and evaluating the performance of agencies in implementing the CFO Act and GMRA. But, there is not a bright line that distinguishes absolutely between successful or unsuccessful agencies based on organizational factors. This suggests that organizational factors, alone, do not make it impossible for any of the 24 agencies to achieve a clean audit opinion eventually.

Instead, the employment of certain management strategies appears to affect agency success in achieving a clean opinion. Among the 15 agencies that were interviewed for this study, those that have never achieved a clean opinion were missing most, if not all, of the successful management strategies. The implication is clear. While organizational characteristics can challenge agencies in their efforts to achieve clean audit opinions, employment of successful management strategies can help to meet these challenges.

A new administration has assumed office. Achieving a clean opinion on the government-wide consolidated financial statement is likely to be a high managerial priority. Success in achieving this goal will depend on bringing the remaining agencies up to a clean opinion while sustaining clean opinions in the others. Agencies without clean opinions are likely to be under substantial pressure from OMB to take the steps necessary to achieve a clean opinion. The findings of this study suggest that policy choices and management initiatives that support the six identified management strategies will help agencies to achieve and sustain clean opinions.

**Recommendation #1. The White House, OMB, and heads of agencies must exhibit tangible interest and involvement in financial reporting.**
Policies should be adopted that reinforce senior leadership interest, such as periodic in-process reviews, organizational goal-setting, and individual performance evaluations that emphasize continuing leadership involvement.

**Recommendation #2. Agency budget decisions and personnel allocations must recognize that audited financial reporting is a recurring requirement.**
Temporary staffing solutions should give way to more permanent arrangements in both the CFO staff and the IG audit staff. A suborganization of trained and qualified accountants and auditors should be established within the CFO and IG organizations. The CFO and IG budgets should contain line-item amounts for preparing and auditing annual financial statements.

**Recommendation #3. CFOs and inspector general auditors should establish ongoing collaborative approaches to financial reporting and audits.**
Each can perform its independent function while still finding ways to lend their respective technical expertise to the overall agency objective of achieving a

clean opinion. Periodic planning meetings and regular feedback systems can help to establish the most beneficial relationship between auditors and financial managers. This will require active participation by the agency CFO and the head of the agency.

**Recommendation #4. Agency leaders need to demonstrate that audited financial statements and clean audit opinions are agency-wide priorities in order to encourage cooperation by functional and line managers.**

Reliable financial reporting requires positive participation by operational and functional managers as well as the financial community. Incentives for participation, through awards and other recognition, have been used successfully in some agencies.

**Recommendation #5. Short-term systems solutions should be employed to help bring the remaining agencies up to a clean audit opinion where integration of new core accounting systems are delayed or under long-term development.**

But short-term systems solutions should not be viewed as replacements for the long-term development of reliable core accounting systems. Leadership dedication and resource applications are necessary to bring systems into compliance with FFMIA. Agencies should make full use of The Joint Financial Management Improvement Project and other government-wide resources for monitoring progress and sharing best practices.

**Recommendation #6. "Heroic effort" should be employed in instances where agencies need to overcome one-time data collection hurdles or to overcome temporary shortcomings in financial information or reporting.**

But repeated use of extraordinary effort is a sign that an agency has not successfully managed the transition to a financial reporting regime that can be sustained in perpetuity. Needed process improvements cannot be replaced by repeated use of extraordinary effort.

**Recommendation #7. Agency leaders, chief financial officers, and inspectors general must recognize that producing reliable financial statements is a recurring annual requirement.**

Achieving a clean opinion is not a one-time event. It must be sustained over time. Temporary resourcing for financial statement preparation must give way to longer-term planning. Agencies must commit resources and personnel to this requirement as part of the operational baseline.

Financial management in the federal government has come a long way since the first attempts by Congress to impose finance and accounting standards. Yet the perception still exists that government oversight of its financial resources in inadequate. Reliable financial information, evidenced by audited financial statements, can go a long way toward improving public confidence in the management of government resources.

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Douglas A. Brook recently completed his Ph.D. studies in public policy at George Mason University. His dissertation research provided much of the information used to compile this report. He is also coeditor, with James Pfiffner, of a new book on the civil service, *The Future of Merit: Twenty Years after the Civil Service Reform Act.*

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