

21st Century Challenges

The Need for Integrity and Stewardship

David M. Walker
Comptroller General
of the United States

Lyceum: University of
Texas McCombs
School of Business
Austin, Texas
September 7, 2005



Webster's Definitions

- **Integrity** – an unimpaired condition; soundness; firm adherence to a code of moral or artistic values; incorruptibility; the quality or state of being complete or undivided; honesty
- **Stewardship** – an individual's responsibility to manage his or her life and property with proper regard to the rights of others; the office, duties, and obligations of a “steward” [manager]

Accountability Breakdowns

- Recent accountability breakdowns in the private sector have come in a variety of forms and bear many names, including Enron, WorldCom, Qwest, Tyco, Adelphia, Global Crossing, Waste Management, Micro Strategy, Superior Federal Savings Bank and Xerox
- The rapid decline and fall of Arthur Andersen LLP has served as a dramatic lesson that will no doubt be the subject of many books and business school case studies.

Accountability Environment

- The credibility of auditing and financial reporting has suffered in the last several years as a result of the accountability failures in the private sector.
- Forces that led to the corporate scandals and audit failures include:
 - Individual and corporate greed
 - Inadequate corporate governance systems
 - Ineffective regulation and oversight of the accounting and auditing profession
 - Inadequate accounting/reporting standards
 - Outdated audit standards and approaches
 - Audit-related expectation gaps
 - Financial managers and advisors working to achieve certain reporting results and focusing on the legal form versus the economic substance of the transactions
 - Unreasonable and inappropriate executive compensation arrangements
 - Auditors and financial professionals doing what was minimally required and actively fighting tighter standards
 - Confusion over whom the auditors work for
 - Auditors delivering services to clients that impaired their independence

We Face a Crisis of Confidence

- Our profession—the performance and accountability profession—currently faces a “crisis of confidence” that must be addressed not only for the good of our profession but also for the good of our country and the nation’s capital markets
- Restoring public trust and confidence in a manner that can be sustained over the long-term will require concerted actions by a various parties in order to address some very real systemic weaknesses plaguing our current corporate and public governance, accountability, and related systems.

Excerpts From the 103rd American Assembly Report: The Future of the Accounting Profession*

- Structural Challenges Facing the Accounting Profession:
 - Rules-based versus principles-based standards
 - A revised and expanded financial reporting model
 - New and enhanced audit and attestation standards
 - The number of major accounting/audit firms
 - A balanced approach to auditor liability and accountability
 - Valuing quality audits and audit personnel
 - Reinvigorating audit committees
 - Preparing for the future—the talent search

Additional Structural Challenges Facing the Accounting Profession

- Redefining success in financial management
- Need for a more continuous audit approach
- The need to move beyond the “going concern” concept in audit reports
- Expectation gaps—what an auditor does and does not do; who is responsible for what
- Thinking about tomorrow and acting accordingly (stewardship)
- Confusion over legal, professional, ethical and other standards—doing what’s right

Key Dimensions of Behavior

- **Illegal**
- **Unprofessional/Unethical**
- **Inappropriate**

Rebuilding Public Trust

In my opinion, for any system to work, it must address three fundamental issues.

- First, provide incentives for people to do the right thing.
- Second, provide transparency to help assure that people do that right thing.
- Finally, have effective accountability mechanisms if people don't do the right thing.

Restoring public trust will require that every participant in the corporate reporting supply chain embrace and live by the following core concepts*

1. **A spirit of transparency**—stop playing games with financial and performance data. Use full disclosure.
2. **A culture of accountability**—management staff, boards, auditors, and stakeholders. High quality, unbiased information to support decision-making.
3. **People of Integrity**—commitment to individual integrity.

Integrity: A Key Principle

- For any financial system to work you need to assure that:
 - The key people have integrity. The importance of integrity cannot be overstated; if key players don't have integrity, nothing else matters.
 - The information provided to key stakeholders is timely and reliable.
 - The people who are assuring the reliability of any financial and non-financial information are qualified and independent both in fact and appearance.

Audit Results for 24 CFO Act Agencies

	<u>2004</u>	<u>2000</u>	<u>1996</u>
Unqualified	18	18	6
Qualified	1	3	4
Disclaimed	<u>5</u>	<u>3</u>	<u>14</u>
Total	24	24	24

Notes: (1) Certain agencies that received unqualified reports in earlier years received other than unqualified opinions in later years.

(2) 2004 includes the Department of Homeland Security (DHS), which became a CFO Act agency in FY 2005. FEMA, which became part of DHS, is included in prior years.

2004 Audit Results for 24 CFO Act Agencies

Unqualified -18 agencies

Includes:

- Treasury – substantially all federal revenues and debt
- Social Security Administration – benefit payments
- Health and Human Services – Medicare and Medicaid benefit payments

Qualified-Small Business Administration

Disclaimer - 5 agencies

Includes:

- Defense
- Department of Homeland Security

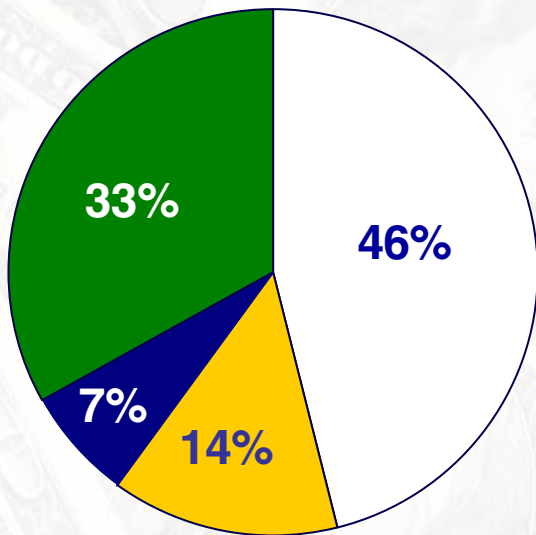
Note: The Department of Homeland Security became a CFO Act Agency at the beginning of FY 2005.

FY2004 GAO Audit Report – Emphasis of a Matter

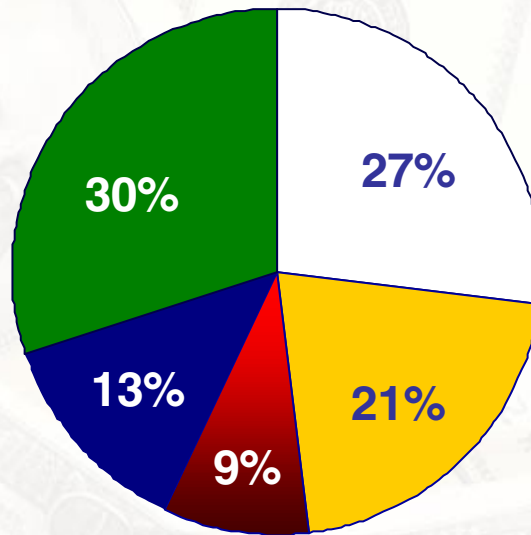
“...it seems clear that the nation’s current fiscal path is unsustainable and that tough choices by the President and the Congress will be necessary in order to address the nation’s large and growing fiscal imbalance.”

Composition of Federal Spending

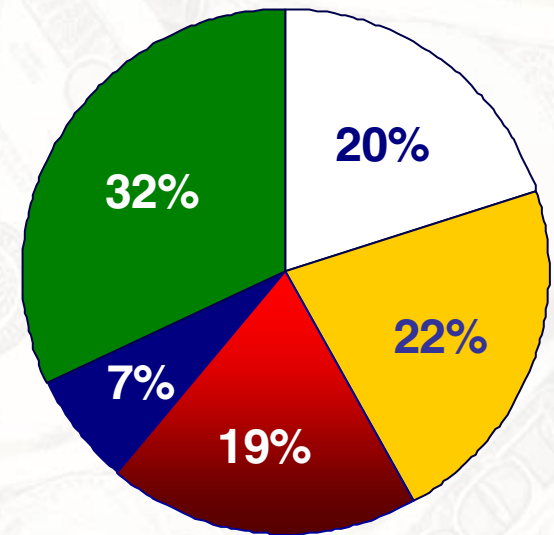
1964



1984



2004



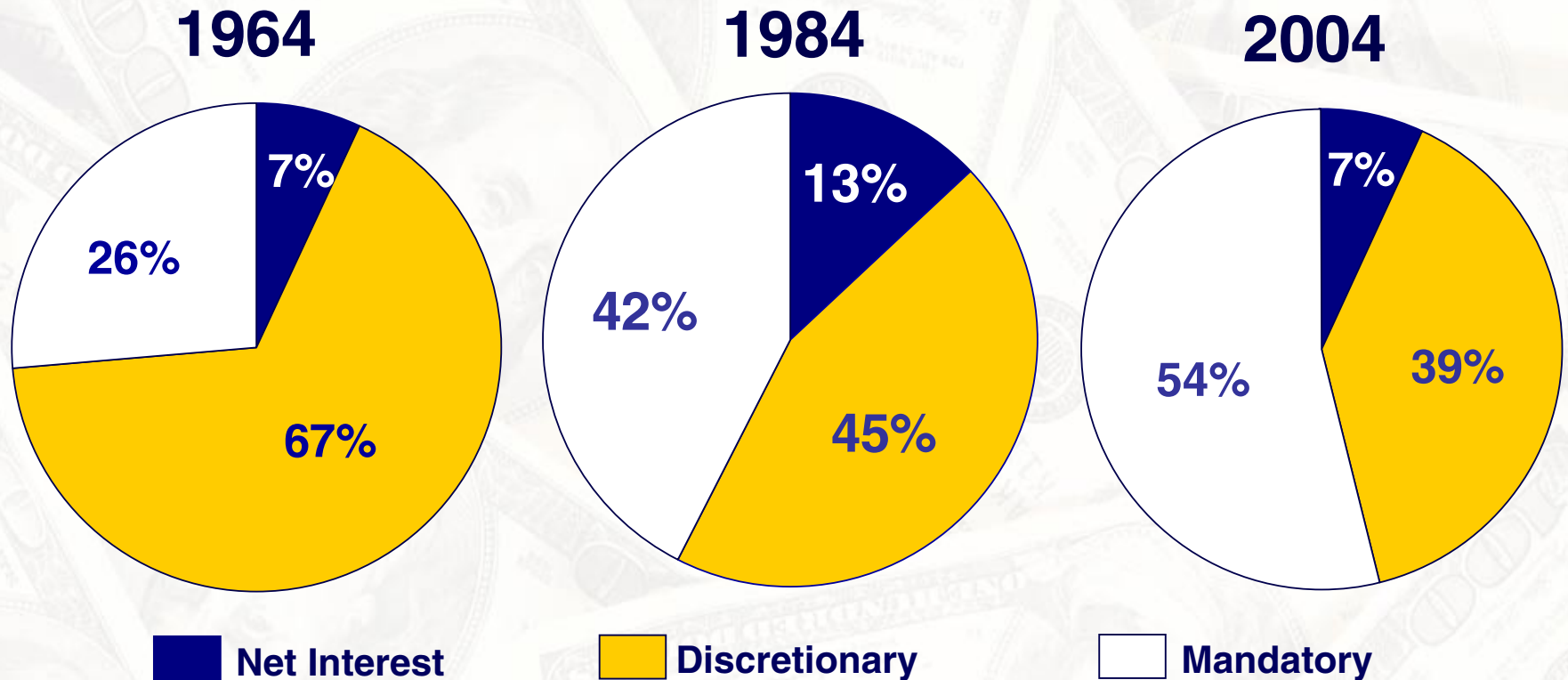
Defense
Net interest

Social Security
All other spending

Medicare & Medicaid

Source: Office of Management and Budget.

Federal Spending for Mandatory and Discretionary Programs



Source: Office of Management and Budget.

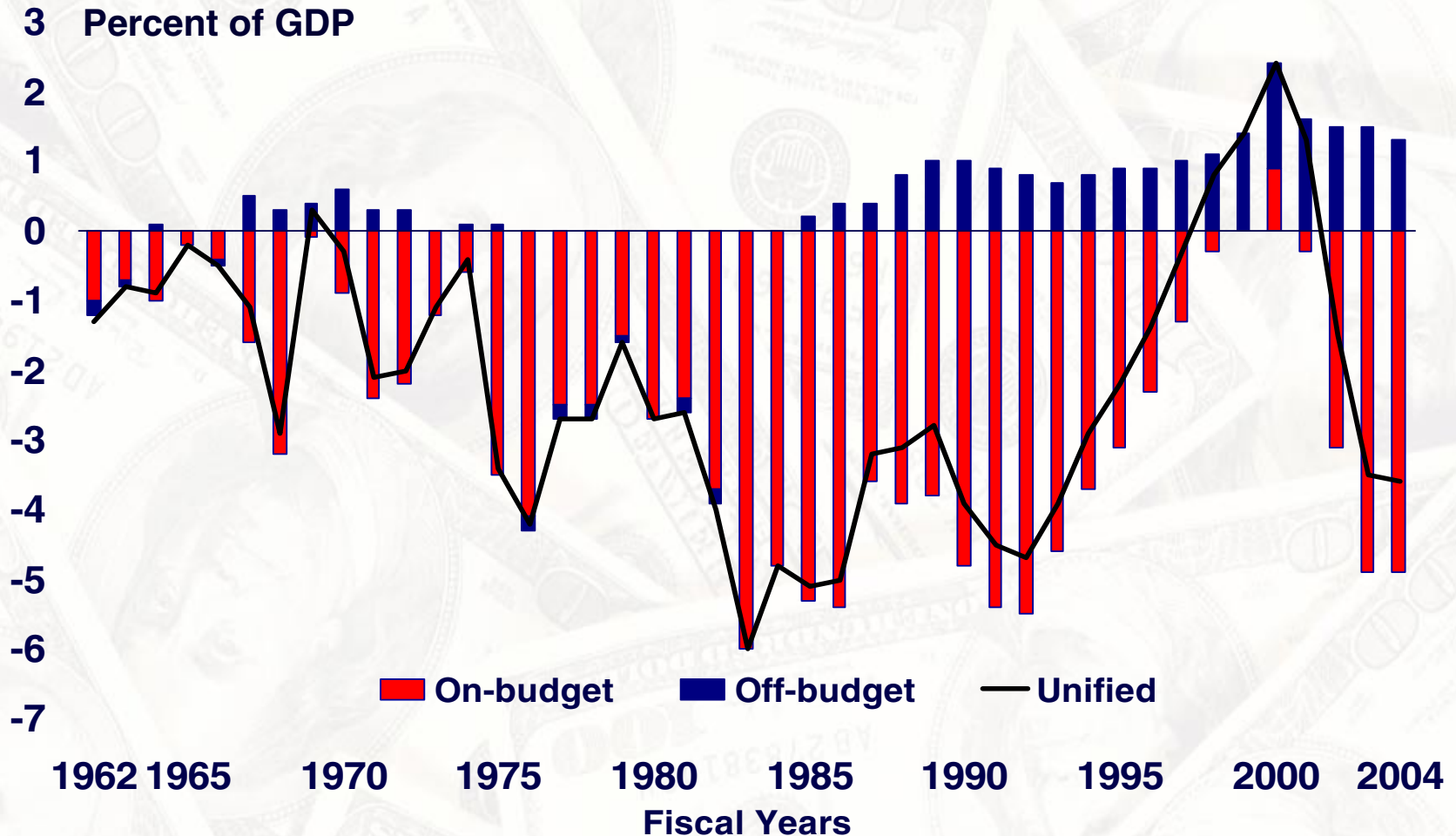
Fiscal Year 2004 Deficit Numbers

	\$ Billion	% of GDP
On-Budget Deficit	(567)	(4.9)
Off-Budget Surplus	155*	1.3
Unified Deficit	(412)	(3.6)

*Includes the \$151 billion Social Security surplus and a \$4 billion surplus for the Postal Service
March 2005

Surplus or Deficit as a Share of GDP

Fiscal Years 1962-2004



Source: Office of Management and Budget and Congressional Budget Office.

Estimated Fiscal Exposures

(in \$ trillions)

	2000	2002	2004
• Explicit liabilities	\$6.9	\$7.8	\$9.1
<ul style="list-style-type: none"> • Publicly held debt • Military & civilian pensions & retiree health • Other 			
• Commitments & Contingencies	0.5	0.8	0.9
<ul style="list-style-type: none"> • E.g., PBGC, undelivered orders 			
• Implicit exposures	13.0	17.8	33.3
<ul style="list-style-type: none"> • Future Social Security benefits 	3.8	4.6	5.2
<ul style="list-style-type: none"> • Future Medicare Part A benefits 	2.7	5.1	8.5
<ul style="list-style-type: none"> • Medicare Part B benefits 	6.5	8.1	11.4
<ul style="list-style-type: none"> • Medicare Part D benefits 	--	--	8.1
Total	\$20.4	\$26.4	\$43.3

Sources: Consolidated Financial Statements.

Note: Estimates for Social Security and Medicare are PV as of January 1 of each year as reported in the Consolidated Financial Statements and all other data are as of September 30. The 2005 Trustees Reports issued in March of this year show that the Social Security and Medicare exposures have increased as follows: Social Security increased to \$5.7 trillion, Medicare Part A increased to \$8.8 trillion, Medicare Part B increased to \$12.4 trillion and Part D increased to \$8.7 trillion. Totals may not add due to rounding.

Growing Fiscal Burden

Another way to think about these fiscal exposures is:

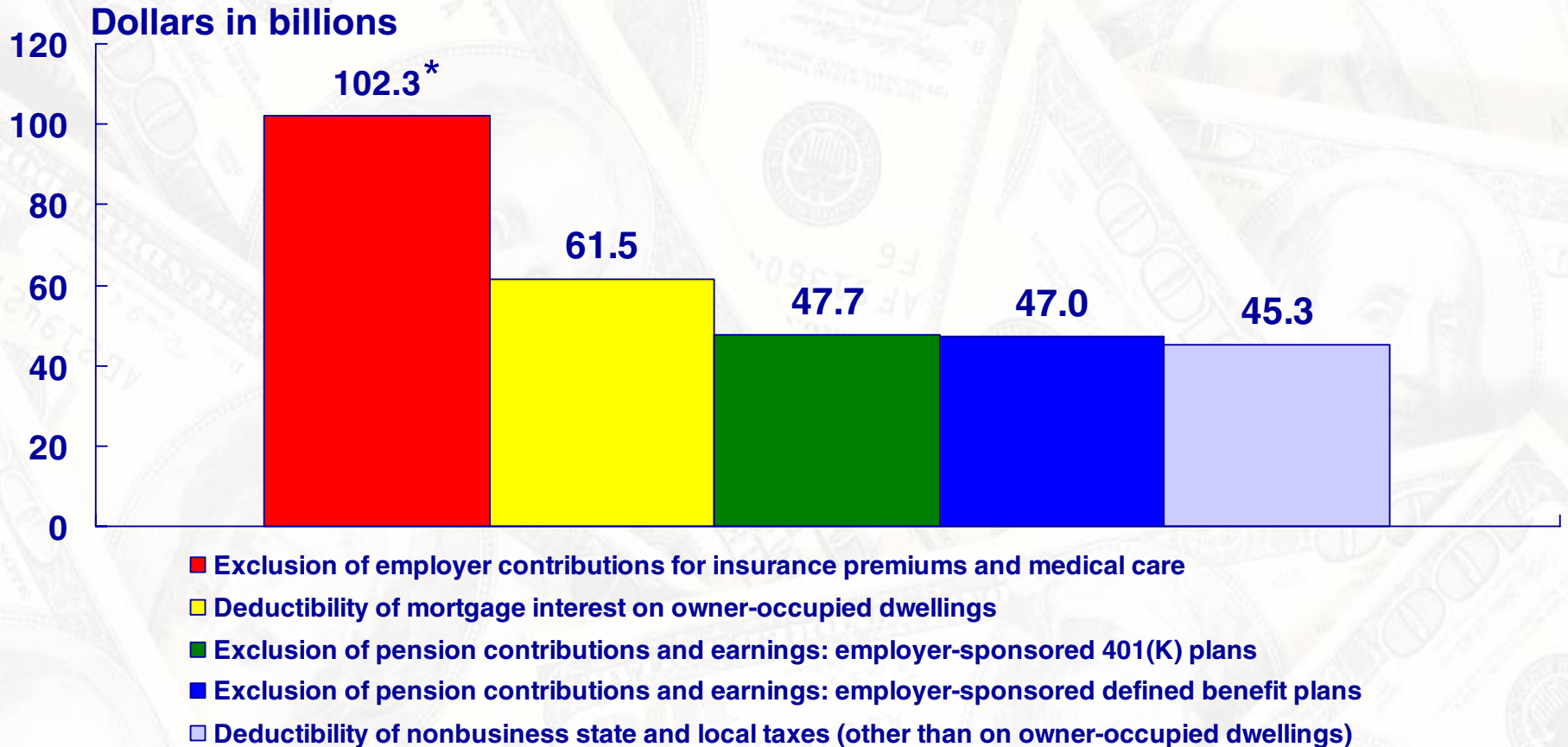
	2000	2002	2004
Fiscal exposures [from previous page]	\$20.4	\$26.4	\$43.3
Per person	72,000	92,000	147,000
Per full-time worker	165,000	214,000	350,000

Fiscal Exposures: The Importance of Looking Beyond the 1st Year

- Terrorism Risk Insurance expansion to aircraft and aircraft engine manufacturers enacted in 2003
 - Estimate for FY 2004: \$3 million income
 - Estimate for 10 years (2004-2013): \$47 million cost
- Health Care Benefit extension to older uniformed services retirees enacted in 2000
 - Estimate for FY 2001: \$223 million cost
 - Estimate for 10 years (2001-2010): \$40.4 billion cost
 - Financial statement liability: \$293 billion
- Medicare Drug Benefit enacted 2003
 - Estimate for CY 2006: \$64.4 billion
 - Estimate for 2006-14: \$851 billion
 - Estimate from program inception through 2079: \$8.7 trillion in present value terms

Sources: Medicare estimates for net federal spending are drawn from the 2005 Medicare Trustees' intermediate estimates. All others are CBO cost estimates in year of enactment and 2001 Consolidated Financial Statement.

Health Care Is the Nation's Top Tax Expenditure in Fiscal Year 2004 (estimated)



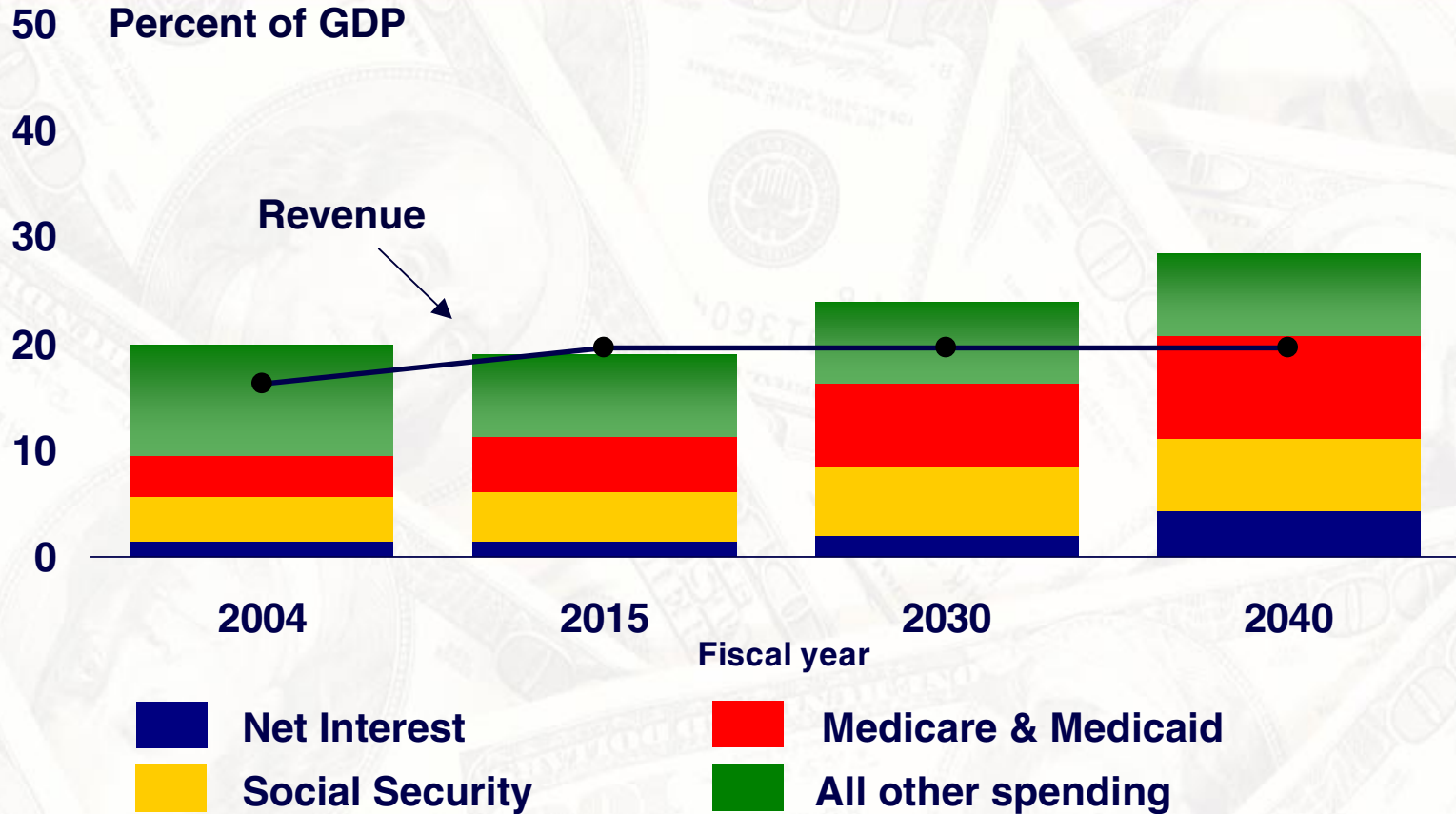
Note: "Tax expenditures" refers to the special tax provisions that are contained in the federal income taxes on individuals and corporations. OMB does not include forgone revenue from other federal taxes such as Social Security and Medicare payroll taxes.

* If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or \$153.5 billion.

Source: Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006*.

Composition of Spending as a Share of GDP

Under Baseline Extended

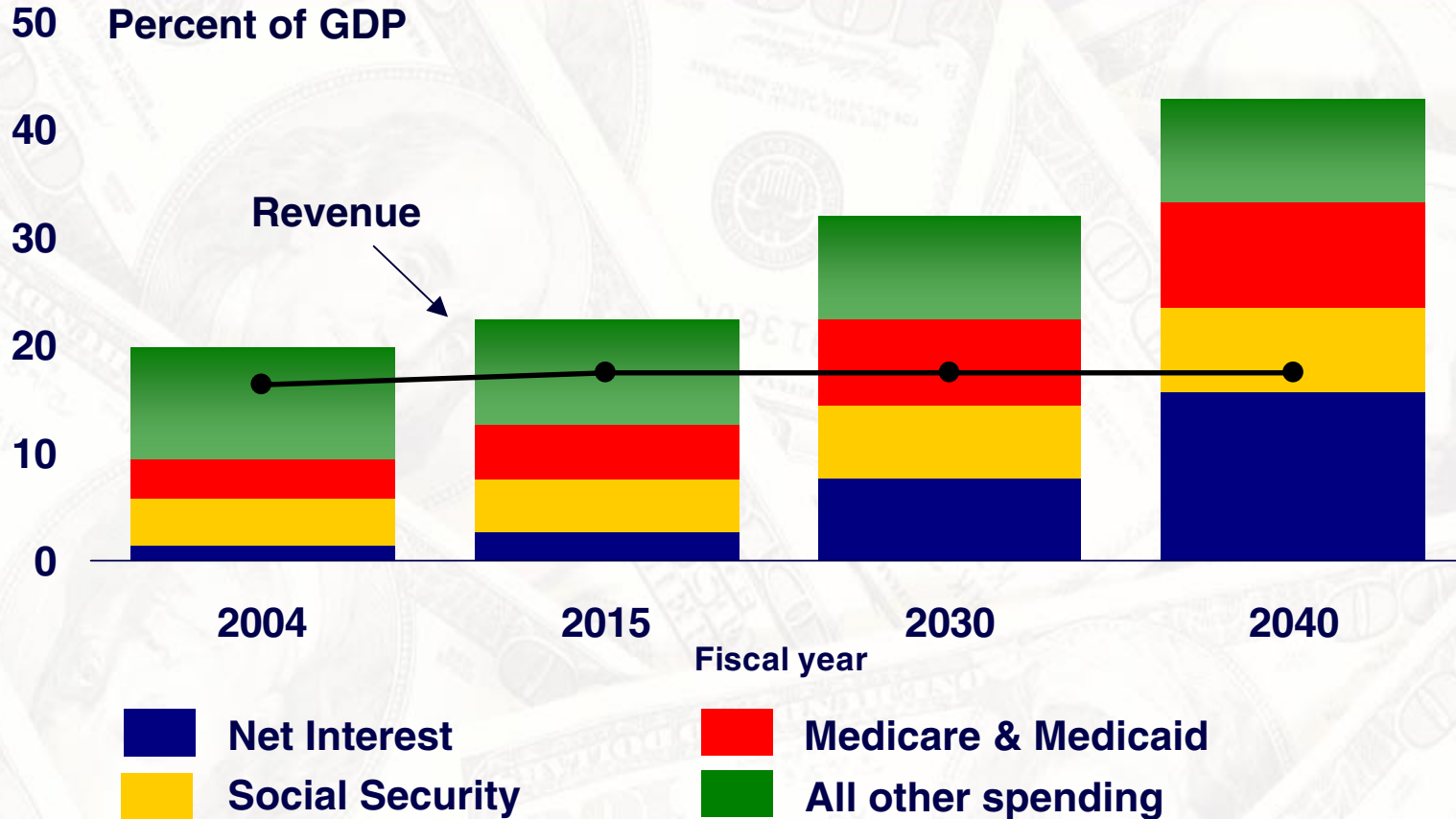


Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO's March 2005 analysis.

Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP after 2005
and All Expiring Tax Provisions are Extended



Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO's March 2005 analysis.

Current Fiscal Policy Is Unsustainable

- **The “Status Quo” is Not an Option**

- We face large and growing structural deficits largely due to known demographic trends and rising health care costs.
- GAO’s simulations show that balancing the budget in 2040 could require actions as large as
 - Cutting total federal spending by 60 percent or
 - Raising federal taxes to 2.5 times today's level

- **Faster Economic Growth Can Help, but It Cannot Solve the Problem**

- Closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
- During the 1990s, the economy grew at an average 3.2 percent per year.
- As a result, we cannot simply grow our way out of this problem. Tough choices will be required.

- **The Sooner We Get Started, the Better**

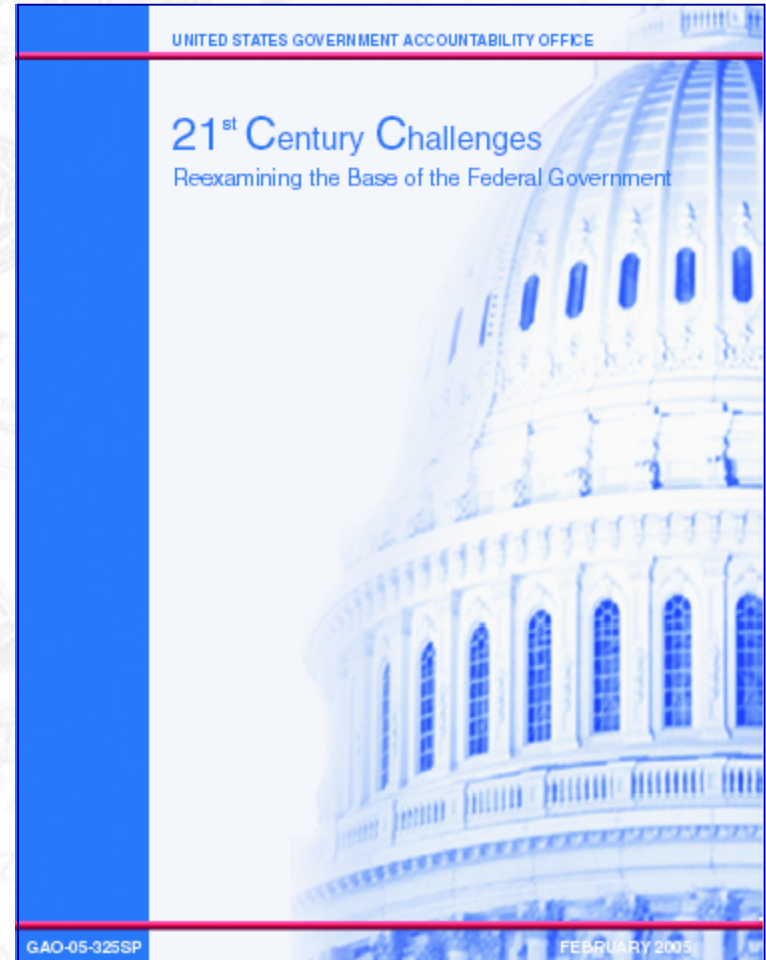
- Less change would be needed, and there would be more time to make adjustments.
- The miracle of compounding would work with us rather than against us.
- Our demographic changes will serve to make reform more difficult over time.

The Way Forward

- New accounting and reporting approaches and new budget control mechanisms
- Develop new metrics for measuring the impact of policies and decisions over the long term
- Reexamine the base—question existing programs, policies and activities

21st Century Challenges Report

- Provides background, framework, and questions to assist in reexamining the base
- Covers entitlements & other mandatory spending, discretionary spending, and tax policies and programs
- Based on GAO's work for the Congress
- Issued February 16, 2005



Twelve Reexamination Areas

MISSION AREAS

- Defense
- Education & Employment
- Financial Regulation & Housing
- Health Care
- Homeland Security
- International Affairs
- Natural Resources, Energy & Environment
- Retirement & Disability
- Science & Technology
- Transportation

CROSSCUTTING AREAS

- Improving Governance
- Reexamining the Tax System

Themes

- Changing Security Threats
- Increasing Global Interdependence
- Demographic Shifts—Aging Population
- Promoting Growth in a Knowledge-Based Economy
- Governance Challenges

Key Concepts in the Accountability Profession

- Public vs. personal interests
- Recognizing the difference between the floor (e.g., law, accounting standards) and the ceiling (e.g., principles, values)
- Doing what is right vs. what is acceptable
- Economic substance vs. legal form
- Being concerned with both fact and appearance (e.g., independence)
- Using judgment vs. completing checklists
- Recognizing that continuing improvement in today's rapidly changing world is essential
- Trust is hard to earn, but easy to lose

Trans **FORMATION**

Webster's definition

**An act, process, or instance of
change in structure appearance,
or character**

**A conversion, revolution,
makeover, alteration, or
renovation**

The Objective of Transformation

To create a more positive future
by maximizing value and mitigating
risk within current and expected
resource levels

Four Key Transformation Dimensions

Key Actions	Primary Responsibility	Secondary Responsibility
1. To make prudent budget & long-term fiscal decisions	The President and the Congress	Agency leadership (both political and career)
2. To enable key transformation efforts while providing protection from abuse of authority	The Congress and the President	Agency leadership (both political and career)
3. To lead key transformation efforts with existing authorities and within existing resource levels	Agency leadership (both political and career)	OMB and other selected government-wide agencies
4. To evaluate reform efforts and conduct continuous improvement initiatives	Agency leadership (both political and career)	Congress, OMB and selected government-wide agencies

Transformation Has Different Dimensions

DOD DHS U. S. Postal Service IRS DOE NASA

Information Sharing
Human Capital Strategy
Financial Management
Information Technology
Sourcing Strategy
Disability Programs
Real Property Management

Note: All of the above are on GAO's High Risk List to one extent or the other.

GAO's Strategic Plan



SERVING THE CONGRESS AND THE NATION GAO'S STRATEGIC PLAN FRAMEWORK

MISSION

GAO exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

THEMES



Long-Term Fiscal Imbalance

National Security

Global Interdependence

Changing Economy

Demographics

Science and Technology

Quality of Life

Governance

GOALS & OBJECTIVES



Provide Timely, Quality Service to the Congress and the Federal Government to ...

Address Current and Emerging Challenges to the Well-Being and Financial Security of the American People *related to ...*

- Health care needs and financing
- Education and protection of children
- Work opportunities and worker protection
- Retirement income security
- Effective system of justice
- Viable communities
- Natural resources use and environmental protection
- Physical infrastructure

Respond to Changing Security Threats and the Challenges of Global Interdependence *involving ...*

- Emerging threats
- Military capabilities and readiness
- Advancement of U.S. interests
- Global market forces

Help Transform the Federal Government's Role and How It Does Business to Meet 21st Century Challenges *by assessing ...*

- Roles in achieving federal objectives
- Government transformation
- Key management challenges and program risks
- Fiscal position and financing of the government

Maximize the Value of GAO by Being a Model Federal Agency and a World-Class Professional Services Organization *in the areas of ...*

- Client and customer satisfaction
- Strategic leadership
- Institutional knowledge and experience
- Process improvement
- Employer of choice

CORE VALUES

Accountability

Integrity

Reliability

GAO's Core Values Help to Maintain Trust in the Public Sector

- **ACCOUNTABILITY**—describes the goal of GAO's work: to enhance the economy, efficiency, effectiveness, and credibility of the federal government
- **INTEGRITY**—describes the high standards GAO sets for itself and its people: to do work that is professional, objective, fact-based, non-partisan, non-ideological, fair, and balanced
- **RELIABILITY**—describes GAO's goal for how its work is received: to produce reports and other products that are timely, accurate, useful, clear, and candid

GAO's Work to Modernize the Accountability Profession

GAO is actively working to modernize and transform the accountability profession, both inside the government and in the private sector, and to lead by example in this area.

- Definition of success in financial management: clean opinion, no major weaknesses in controls or compliance, and financial systems that produce timely, accurate and useful information for management
- Opinion on system of internal control
- 2003 revision of *Government Auditing Standards*
- Creation of the U.S Auditing Standards Coordinating Forum (i.e., GAO, PCAOB, ASB)
- Coordination with accountability organizations around the world (e.g., INTOSAI)
- Modernization of the accounting/reporting and audit models
- Assure appropriate treatment of restatements by auditors and others
- Monitor implementation of the Sarbanes-Oxley Act, including providing suggestions for possible actions by the PCAOB and the SEC in connection with the internal control reporting requirements under Section 404
- Consider whether reform elements similar to those in Sarbanes-Oxley make sense for the federal government

The Federal Financial Audit Environment

The federal financial audit environment is evolving:

- Closer to an opinion on the consolidated financial statements of the U.S. government (CFS), but DOD is the key challenge
- GAO, as the auditor of the CFS, needs to be able to use the work of the auditors of the agency financial statements
- Agencies need to meet accelerated due dates, maintain unqualified opinions, and address their internal control and financial management system deficiencies
- More timely financial and performance reporting should not come at the price of less reliable reporting

Selected Federal Government Reporting Challenges

- **Financial and Performance Reporting**

- long-range fiscal challenges (e.g., per capita burden, sustainability, intergenerational impact)
- “trust funds” (e.g., restricted vs. unrestricted revenues, intra-governmental obligations)
- DOD assets, liabilities, and contingencies
- performance reporting
- summary annual report

- **Audit Reporting**

- system of internal control
- financial vs. performance vs. other information
- restatements

Selected Government Accountability Issues

Leading by Example

- **Definition of success in financial management**
 - Clean opinion on financial statements
 - No major control weaknesses
 - No major compliance issues
 - Systems that produce timely, accurate, and useful financial and management information
- **Scope of audit**
 - Internal controls (current)
 - Compliance matters (current)
 - Performance and projection information (future)
- **Additional issues**
 - Accelerated and enhanced financial reporting
 - Audit/financial management committees

How Do We Move Forward?

- Good governance and accountability are critical
 - in the private sector to promote efficiency and effectiveness in the capital and credit markets, and overall economic growth, both domestically and internationally
 - in the public sector for the effective and credible functioning of a healthy democracy, and in fulfilling the government's responsibility to citizens and taxpayers
 - in both sectors to support a healthy economy that provides economic opportunities and benefits to citizens
- Sorting out the needs and effective and appropriate governance and accountability mechanisms for different sectors and types of organizations and on an international scale will be critical

Financial Audit Peer Review

- Performed by a large, international accounting firm (KPMG LLP) in accordance with AICPA peer review standards and Government Auditing Standards
- Clean opinion – fourth straight time
- Reviewers cited numerous good practices:
 - Major issues and significant consultations well documented
 - Internal inspection and peer review taken seriously
 - Comprehensive sampling plans used
 - Good use of tracking sheets and routing slips
- Reviewers also suggested clarifying policies and procedures for documenting references to prior year testing and the assessment of management's internal control evaluation process

International Peer Review Team

- Australia
- Mexico
- Norway
- South Africa
- Canada
- Netherlands
- Sweden

Performance Audit Peer Review

- **Clean Opinion**
- **Global Good Practices**
 - Strategic planning process
 - Audit risk assessment
 - Agency Protocols
 - Use of experts
 - E.A.G.L.E
 - Report design
- **Other Observations**
 - Distinguishing between audit and non-audit services
 - Reporting additional details on sources of critical information and methodological choices
 - Reviewing the quality assurance system for further efficiencies
 - Streamlining the documentation requirements
 - Making the inspection program more efficient
- **Report Has Been Made Public**

Three Key Ingredients Needed for These Challenging and Changing Times

- ***Courage***
- ***Integrity***
- ***Innovation***

21st Century Challenges

The Need for Integrity and Stewardship

David M. Walker
Comptroller General
of the United States

Lyceum: University of
Texas McCombs
School of Business
Austin, Texas
September 7, 2005

