

YOU'VE COME A LONG WAY BABY.

AN EVALUATION OF THE FEDERAL AGENCIES'  
ANNUAL FINANCIAL REPORTING

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“YOU'VE COME A LONG WAY BABY.” That saying was coined originally for a cigarette, but it can be applied equally to the federal agencies' adoption of annual financial reporting. In 1991, only three agencies were able to issue auditable financial statements. The process required 11 months, and only one received an unqualified auditors' opinion.

Today, every one of the 24 agencies covered by the Chief Financial Officers (CFO) Act (plus almost 100 smaller agencies) issue their audited financial statements within 45 days after the end of the fiscal year, and as many as 22 of the CFO Act agencies have received an unqualified opinion at one time or another.

The process doesn't stop there. The agencies append to their financial statements the reports on internal control required by the Federal Managers' Financial Integrity Act (FMFIA), on systems required by the Federal Financial Management Improvement Act (FFMIA), on performance required by the Government Performance and Results Act (GPRA), on improper payments required by the Improper Payments Information Act (IPIA), on management and performance challenges required by the Reports Consolidation Act (RCA), and a host of other information on financial management, the status of management functions, and current and future conditions, events, trends, etc. that could affect the agency. These reports have come to be called Performance and Accountability Reports (PARs).

But providing such considerable information has also caused problems. The reports are exceedingly long—some topping out at more than 400 pages—which means they are read by only a few hardy persons. Considerable time is required to prepare the reports—time that could be better spent analyzing the information. It appears that they have not affected the budget process to any significant degree.

For FY 2007, the Office of Management and Budget (OMB) decided to determine whether there might a better way for agencies to report on their performance and accountability. It authorized a Pilot Program whereby those agencies that desired could issue an alternative to the PAR. The alternative would consist of three separate reports:

**An Agency Financial Report (AFR)** that presents both the highlights of the agency's financial position and results and its audited financial statements, as well as information regarding the status of and outlook for the agency's internal control, financial systems, management and performance challenges, improper payments and other management activities. The report was to be issued no later than Nov. 15, or 45 days

after the end of the fiscal year, in order that the information could be available to inform the budget development process.

An **Annual Performance Report (APR)**, based on the requirements of the GPRA. The notion was that the APR would be issued in early February, simultaneous with the transmission of Congressional Budget Justifications. It could then contain up-to-date performance information, while possibly influencing congressional budget deliberations.

A **Highlights Report** (since retitled the Citizens' Report), which would integrate financial information from the AFR with performance information in the APR to report the costs of performance, plus convey the most significant information about the agency's goals, accomplishments, challenges, etc. The highlights report should be no more than 25 pages long, and have a user-friendly format that could be understood by readers with little technical background in the areas covered by the report. Because the report would contain performance information, it could not be issued earlier than the APR.

AGA's Certificate of Excellence in Accountability Reporting program has been reviewing agency PARs for the past 10 years. AGA was therefore asked to review the AFR portion of the Pilot Program to ascertain whether the AFRs, as defined and prepared, represents the best way to demonstrate performance and accountability in as transparent and accessible a manner as possible. The following is a report on how AGA undertook the evaluation, what it concluded and most important, what it is recommending.<sup>1</sup>

### **HOW AGA UNDERTOOK THE EVALUATION OF THE AFRs**

AGA feels strongly that a sound reporting protocol has to be based on a sound rationale, and not just statutory requirements. Accordingly, the first step was to ascertain the objectives for the agencies' reports of performance and accountability. OMB had informally identified three:

- provide **transparency** into government finances and performance, that is, the financial results of government operations over time, the effectiveness of government programs, the management of government resources, etc.;
- demonstrate the existence and effectiveness of **internal controls** that will prevent the misuse and abuse of financial and other resources, and assure the reliability of financial and performance information used for the annual audited financial statements as well as for other purposes, for example, the CMS databases used to process Medicare and Medicaid payments, the databases from which citizens can obtain the data required by the Strengthening Transparency and Accountability in Federal Spending Act of 2008, etc.; and

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<sup>1</sup> In a related project, the Mercatus Center reviewed the Annual Performance Report and Highlights Report portions of the Pilot Program.

- provide decision-makers with the information needed to make sound resource allocation and management **decisions**, that is, to achieve better outcomes, reduced fraud, error, waste.

We believe there is a fourth objective, **process improvement and discipline**. Since performance and accountability reporting is the means to the end, process improvement and discipline is often overlooked by persons who believe the only reason to produce a financial report is for the report to be used for a specific purpose. However, as long as reports present information, the requirement to prepare a report requires and drives the establishment and improvement of systems necessary to accumulate and report the information. This can produce several significant benefits.

- To issue reports, agencies need to establish or at least improve information systems needed to accumulate the information.
- In doing so, agency personnel gain considerable insight into the agencies' financial and program operations that they heretofore did not have.
- Furthermore, since stakeholders want the information used for decision-making and control to be accurate, reports provide a foundation for a self-assertion and/or an independent attestation of the information's reliability. This would not be available in the absence of a report.
- Finally, since the person providing the assertion or attestation will not be able to check every item in the report, he or she will look to the agency's internal control to assure reliability. This will compel the organization to evaluate and assure that its controls are functioning properly.

The second step in the evaluation was to identify the information the agencies are required to provide in an AFR. They are:

- an agency head message.
- a Management's Discussion and Analysis (MD&A), of which the major elements are the agency's mission and organization structure, a high-level discussion of performance information, an analysis of financial statements, an analysis of systems, controls and legal compliance, "forward-looking information" and information about other management activities.
- a financial section, comprised of a letter from the Chief Financial Officer letter and the agency's financial statements and accompanying auditors' report.
- other accompanying information (OAI), which are the Inspector General's (IG) summary of the most serious management and performance challenges, a summary of the material weaknesses and non-compliances reported by management and the auditors, and the detailed information required by the IPIA.

Third, we considered whether the Pilot Program reporting requirements, listed above, in and of themselves would fulfill the four objectives for preparing the reports, that is, as-

suming the reports are prepared in accordance with the requirements. We concluded that reports prepared in accordance with the AFR requirements would partially fulfill the four reasons, AND with a few adjustments as recommended later in this evaluation and considering the information included in the two other reports, the AFRs could fully fulfill the requirements.

Specifically, AFRs provide transparency into at least an agency's finances and management of resources and, to a certain extent, into its program performance. However, considering the growing tendency of people to use the Internet to obtain information, the placement of performance information on [expectmore.gov](http://expectmore.gov) is probably the most effective and efficient way to make the public aware of the results of program performance.

The AFRs, as currently defined, fulfill the second objective by demonstrating the existence and effectiveness of internal control over financial and related resources and systems, but not necessarily the delivery and reporting of program performance. Achieving the latter would require adjustments to the current reporting requirements.

Fulfilling the third objective, to support decision-making, requires that the decision-makers have the information prior to the time the first decisions, namely the budget-development decisions, are made. It also requires that the decision-makers know how and want to use the information to support decisions. For the executive branch, the issue is the timeliness of the information, which will be addressed in the recommendations. For Congress, the issue is a lack of willingness to use the information, based on a lack of familiarity with and understanding of the information. This too is addressed in the recommendations.

Finally, the defined reporting requirements fulfill the fourth objective by providing a foundation for process improvement and discipline, particularly in respect of the financial systems and information.

The fourth step was to review the Pilot Program agencies' AFRs to ascertain how they complied with the Pilot Program's reporting requirements—particularly in comparison to how the non-Pilot Program agencies complied with their reporting requirements. The agencies whose reports were reviewed are listed in Figure 1.

## **WHAT AGA FOUND REVIEWING THE REPORTS**

The findings from the reviews of each Pilot Program agency's AFR are available in Figure 2. They provide the foundation for the recommendations presented in the subsequent section.

The findings are presented generally in the sequence in which the material would be noted in the AFRs. Interestingly, much of what was noted reviewing the AFRs pertain equally to the PARs reviewed.

## **RECOMMENDATIONS**

AGA believes the Pilot Program approach can provide a foundation for meeting the reporting objectives. However, we believe there are several adjustments that can be made that would improve the ability of the AFR to meet the above objectives.<sup>2</sup>

The recommendations are presented below, also in generally the same order in which they would appear in the AFR. Since many of the findings are applicable to both the PARs and the AFRs, most of the recommendations are equally appropriate for both. Those recommendations that pertain to just the AFRs are marked with an asterisk. Also, two recommendations pertain to the other elements in the reporting process—the APR and the Citizens’ Report. They are presented at the end of this section.

Several of the recommendations appear to have already been addressed in the OMB Circular A-136 guidance for the FY 2008 Pilot Program, which is commendable. In actuality, however, reporting is only one element in financial and performance management. The requirements of the CFO Act, which initiated the financial reporting program as well as several other reforms, are almost 20 years old. Examining all aspects of financial management—that is, organization, systems, auditing—and then updating the Act and the related statutes with full consideration of the role of the budget and program communities would enable the government to meet the totality of its financial and program management needs. This could be done in a cost-effective manner without losing the tremendous progress gained during the last 18 years. Several reports and articles have been written providing recommendations for the entire financial management function.<sup>3</sup>

### **Recommendations for the Performance and Accountability Report and the Agency Financial Report**

**Strengthen the Guidance for Preparing the Reports.** The Circular A-136 guidance for PARs has basically not changed from OMB Bulletin 01-09 to OMB Circular A-136 for Fiscal Years 2006, 2007 and 2008. This is probably because OMB does not start the update soon enough and only has time to modify the prior year’s guidance. As a result, the guidance for the alternative PARs, that is, the AFR and Citizens Report, is hard to follow.

For example, A-136 begins with a general section that defines what the PAR and the AFR must contain, even though the PAR is the only report prepared by the non-Pilot Program agencies and the AFR is but one of three reports prepared by the Pilot Program

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<sup>2</sup> The recommendations were developed following the review and analysis of the Agency Financial Reports prepared by the nine CFO Act agencies that participated in the Pilot Program and the PARs prepared by eleven CFO Act agencies. They were presented as proposed recommendations at a session of the 2008 Association of Government Accountants Professional Development Conference and reflect the comments and suggestions made by the session’s attendees. The recommendations were then reviewed by the Certificate of Excellence in Accountability Reporting Board and adjustments made as appropriate.

<sup>3</sup> Moving from Scorekeeper to Strategic Partner: Improving Financial Management in the Federal government, October 2006, National Academy of Public Administration, Washington, D. C.; “What Could be Next for Federal Financial Management?” Journal of Governmental Financial Management, Fall 2006

agencies. Hence, the general section provides an overview of what the PAR must contain, leaving the detailed requirements to subsequent sections. For the Pilot Program agencies, the general section was the only section providing the detail for what the AFR should contain, and that was limited to the content for the agency head message; the MD&A portion on performance, which was sparse, and no other parts of the MD&A; and the financial section, but only to the same extent that guidance is provided in the general section for the PAR's financial section. For the OAI, Pilot Program agencies are referred to the section providing guidance for the PAR's OAI.

Guidance for the MD&A is as necessary for an AFR as it is for a PAR. Since SFFAS No. 15 is applicable to AFRs, as well as PARs, the only major difference between an AFR and a PAR is that the former does not have a performance section. An argument could be made that due to the newness of the AFRs, more, not less, guidance is needed, and that the guidance should be explicit rather than general as to what is expected.

We therefore have a three-part recommendation.

**Restructure** the A-136 guidance so that it is easier to follow. One alternative would be to have a general section in A-136 that identifies no more than the purpose of that section, the required reports and the required parts in each report; and a separate MD&A section in A-136 for each of the two types of reports (PAR and AFR). A second alternative would be to have one MD&A section in A-136, thereby reflecting that the MDAs should be basically the same in both types of reports. This single section would identify and provide specific guidance for any MD&A sub-parts that are supposed to be different in the two types of reports.

**Expand the guidance** to help assure the MDAs provide complete, meaningful, readily understandable information that enable readers to obtain an understanding of the efficiency and effectiveness of the agencies' performance and management of resources. This would include directions to the agencies to ascertain the audience(s) for their agency's AFR or PAR and to develop the report around a message appropriate for that audience. It would also include several of the matters addressed in the following recommendations.

**Begin the A-136 updating process earlier** in order to leave enough time to prepare the guidance with which the desired improvements can be made.

**Specify Size Limitations and Monitor Adherence.** The AFRs are smaller than the PARs, but there are still wide variations in size among the PARs and the AFRs. Also, many agencies present MD&A-type information in other report sections. These practices suggest that the guidance regarding size of the reports include limitations for not just the agency head message and the MD&A, but for the entire report and its other components.

Since a major determinant of the amount of information an individual agency can and should report is the agency's size and scope, any size limitations should be tailored to the nature and type of agency. For example, although the present 30-page restriction for an

AFR's agency head message and MD&A appears about right for larger agencies with numerous components and/or a broad range of services, fewer pages might be appropriate for smaller agencies that do not have numerous components and/or services.

Finally, agencies should be reminded not to circumvent size limitations by placing information intended for presentation in the MD&A in other sections of the PAR or AFR. OMB should then identify agencies that exceed the size limitations and work with them to preclude exceeding the limit in subsequent years' reports.

**Match the Report's Name to its Content.**\* The AFR is more than a financial report. It presents information about the agency's accomplishments, challenges, the status of its controls, at least some information about its program performance and often more. Although some persons might think the term "financial" encompasses all of these elements, to most readers, the reports are far more than financial.

Returning to the name Agency Accountability Report, as envisioned by both the Government Management Reform Act (GMRA) and the Reports Consolidation Act (RCA), and as used by OMB and the agencies prior to FY 2002, would signal preparers that this is the report with which they demonstrate accountability for their use of resources. Users would be alerted to the fact that the report tells them far more than just the agency's financial position and results; that is that it covers all aspects of an agency's accountability.

**Make Internet Links Direct.** The Internet links to the APR, Citizens' Report, expect-more.gov, results.gov and other sites that provide information about performance and accountability should not only be present, but be clearly identified in the reports and on the agencies' home pages. The links need to take the user directly to the indicated sites. For instance, the link provided for the APR should be to a standalone APR that is separate from the Congressional Budget Justification, or at least separately presented and identified within the Congressional Budget Justification.

**Add Balance and Candor to the Agency Head Message.** As long as the agency head messages present only positive information, the reports will come across as sterile. Credibility is also affected. This matter can be addressed by including directions in the guidance that the agency head messages should also address difficulties in achieving goals, other performance problems, challenges facing the agency and other issues that would enable readers to obtain a full understanding of the agency and its programs.

**Enrich the Performance Information.**\* The lack of a Performance Section in the AFR suggests that more, rather than less, performance information in the MD&A would be appropriate, primarily to assure internal control and keep driving management improvements, but also to avoid having the report be bereft of any accountability for performance. Most of the AFRs' MD&As presented vignettes of various programs. These might be interesting, but they do not give a sense of the agency's overall performance. It is also inconsistent with the CFO community's statements that people should focus on the important performance information, not the financial information.

A better approach would be to include in the MD&A the overall results for each strategic goal and the year-to-year trends for those results, even if based on estimated results for the latest fiscal year, plus the individual results for a small number of the most important performance goals. This would include less-than-desirable results as well as positive results.

With this kind of information, the agencies would be able to demonstrate they have accumulated their performance data soon enough after year-end to be useful and used for the development of the subsequent years' budgets; and to present the trends in overall performance. There would be no question as to their compliance with Statement of Federal Financial Accounting Standards 15 *Management's Discussion and Analysis*. This standard, which is part of generally accepted accounting principles, requires that the MD&A address performance goals, objectives and results.

**Accelerate the Availability of Performance Information.** In 2002, in response to OMB's recognition and direction that not publishing financial information until five months after the end of the year is not appropriate, agencies planned and implemented the procedures to obtain, organize and present the information sooner. The accelerated processes included, where necessary, estimates built on rational estimating protocols and the most recent reliable data.

OMB apparently has not addressed the same need for timely performance information. This absence of action sends an undesirable signal that it is less important to have performance information shortly after the end of a reporting period than it is to have financial information shortly after the end of the period. This lower level of concern is also inconsistent with the importance being placed on improving performance.

Furthermore, considering performance information as part of budget analysis in the executive branch is probably more important than considering it in the legislative branch budget analysis. If, however, performance information is published so late that it can be used only in the legislative phase, it is akin to throwing performance information in the Congress' face.

Finally, the Mercatus Center's evaluation of the Annual Performance Reports showed that delaying the publication of performance information from Nov. 15 to early February had no effect on the performance information's availability or quality.

Hence, OMB should direct agencies to plan and implement the procedures to obtain, organize, and have performance information available 45 days after the end of the year, the same as they do for financial information. In this way, selected performance information could be presented in the AFR at Nov. 15, and the complete performance information could be provided to Congress in early February, simultaneous with the Congressional Budget Justification.

**Improve the Performance Information's Reliability.** Including more performance information in the MD&A could produce another benefit. It provides a foundation for increasing readers' confidence in the reliability of the agency's performance information.

One approach could be to have the persons who work with the information undertake a process to assure and report on the reliability of the data the agency presents in its MD&A and elsewhere. That, of course, should be done no matter what. However, this is not sufficient, at least during the beginning of a program to report performance information. Experience shows that preparers are not likely to report that the data they produce are inaccurate.

Another approach could be to require that the newly appointed Performance Improvement Officers assert on the completeness and reliability of the data. This approach suffers, however, due to the lack of independence associated with self-assertion.

The best approach would be to return to the practice of requiring the external auditor—who is both independent of the process and required to consider the source of information presented in the MD&A—to review the existence and completeness of assertions pertaining to the performance measures included in the MD&A, and report those internal controls that have not been properly designed and placed in operation. This entails time and a cost, but that is a small price to pay to assure the data's reliability, particularly in relation to the amounts expended to accumulate the data. Excess costs to obtain this level of assurance, which evidently occurred in the past, could be prevented by permitting management to advise the auditors that performance data requiring extensive and unusually costly review procedures can be excluded from the process. The auditors' report would then reflect this scope limitation.

An independent auditor's review of the controls underlying the reported performance measures might result in reports of poor controls and/or unreliable data. The proper response when this occurs is not to stop requiring the reports, but instead to correct the control deficiencies.

**Integrate Performance and Costs.** As determined by the reviews of the reports, with but a few exceptions, the AFRs and PARs (and the Highlights Reports) did not present performance in financial terms. Agencies should be required to present each strategic goal with the resources associated with it—budget appropriations, budget obligations, expenditures, and/or net cost. This would enable readers to understand how many resources are devoted to each strategic goal and how much performance is costing. It would also drive the agencies that currently cannot present this information to establish cost accounting systems that could identify the costs of their programs and outputs. Such systems are critical to the effective management of resources. Finally, presenting information about the costs of the agency's services is likely to stimulate interest in where the money or other assets are going or will have to go in the future.

The agencies should also be required to present one or more measures of efficiency or cost effectiveness that are meaningful indicators of how the agency, as a whole, is func-

tioning (that is, measures that relate outputs or outcomes to inputs). This would demonstrate the concern the agencies have for the efficient and effective use of resources, another element of accountability. It would also help stakeholders evaluate whether the results accomplished are worth the inputs required. This is always a matter of concern, and even more so when resources are limited.

A possible contributor to the inconsistent presentation of the costs to pursue each strategic goal could be the ambiguous directions in OMB Circular A-136. The directions provided for the FY 2007 AFRs and PARs stated:

“The SNC [Statement of Net Cost] classifies revenue and cost information by major program and the related supporting schedules in the notes classify revenue and cost information by suborganization or responsibility segment and by major program (see Notes 21 and 22). (Suborganizations are considered to be generally equivalent to responsibility segments.) Preparers of the SNC should present responsibility segments that align directly with the major goal(s) and output(s) described in the entity's strategic and performance plans, required by GPRA.”

The agencies could plausibly interpret these directions as meaning that while the responsibility segments should be consistent with the strategic goals required by GPRA, the financial reporting can be by program. Since, the Circular does not direct that the programs be consistent with the strategic goals, many agencies present financial information for what they consider to be their programs, and these programs have no relationship to their strategic goals.

This matter might be fixed in coming years by the change made in OMB Circular A-136 for FY 2008. The new language states:

“The SNC should show the net cost of operations for the reporting entity, as a whole, by major program, which should relate to the major goal(s) and output(s) described in the entity's strategic and performance plans, required by GPRA.”

**Provide Meaningful Analysis of Financial Information.** The OMB Circular A-136 directions for the Analysis of Entity's Financial Statement and Stewardship Information direct the agencies to present the major changes in balances before presenting the relevance of the balances. This should be reversed. Readers would be able to understand the changes better if they already knew the nature of what has changed. In addition to Fund Balance with Treasury, which is the largest asset account for most agencies, agencies should be directed to explain the relevance of those accounts that are unique to the agency's operations. For example, a major lending agency should explain the accounts associated with the loan programs; an agency with substantial property holdings should explain the property, plant and equipment accounts.

Second, the directions require an identification of the major changes in types or amounts of assets, liabilities, etc. This information is already available in the financial statements. The guidance should be modified to require an explanation of the reasons for the changes, not just the amounts of changes, in order that users can obtain maximum insight

into the agency's financial position and results and whether that position has improved or deteriorated as a result of the agency's activities. The directions should also make clear that identifying the changes in a financial statement line item's components is not explaining the reason for the change. What is expected is the underlying cause of the change. (Providing illustrations in A-136 of effective analysis would probably help to improve the quality of the analysis presented by the agencies.)

**Move the Emphasis on the Reporting on Internal Control.** Agencies' management has been required since 1983 to evaluate and report on the agency's internal control. This work has been performed with varying degrees of quality. Following the enactment of the Sarbanes-Oxley Act in 2002, OMB overlaid the existing requirement with an additional requirement for a separate report on internal control over financial reporting. Since agencies' managements were, to at least some degree, already evaluating and reporting on internal control over financial reporting as part of their reports on internal control, plus the auditors were evaluating internal control over financial reporting in order to conduct the financial audits, agencies were reporting twice, and sometimes thrice, the same weaknesses in internal control. The resulting confusion was perhaps one of the reasons a requirement was added to include in the FY 2007 AFRs and PARs tables that listed by name the material weaknesses reported under the three separate evaluations, and to assure that the name for each weakness was short and consistent.

The duplication inherent in requiring a separate evaluation and report on internal control over financial reporting appears to be not worth the effort, particularly when the financial management community is faced with other emerging requirements and shrinking personnel resources. In other words, the goal of requiring a separate evaluation and report of internal control over financial reporting apparently has been achieved. Management has documented the systems plus the manner in which they are evaluated.

Also, the need to focus on internal control over financial reporting detracts from the attention the agencies should be devoting to internal control over other areas that are likely to be more significant to Congress and the public, for example, benefit payment systems, procurement and grants data systems, and potential conflicts of interest.

It may be time to rescind the requirement for the separate evaluation and report on internal control over financial reporting. In doing so, OMB should advise the agencies not to reduce the intensity of the financial reporting portions of the evaluation of internal control conducted pursuant to the requirements of the Federal Financial Management Improvement Act. OMB would be sending a signal that although internal control is important for financial processes and reporting, it is equally important for program operations.

**Assure All Control Weaknesses are Addressed.** The Chief Financial Officer letters are required to report the planned time frames for "correcting audit weaknesses and noncompliances." Auditors do not use the term "weaknesses" without qualifying the word. The matters auditors report are termed "material weaknesses" and "significant deficiencies." (They may also separately report other deficiencies in internal control that are not required to be included in the audit report, but that the auditors deem necessary to commu-

nicate. The separate report is required to be referenced in the auditors' report on internal control.)

The Chief Financial Officer letters, in meeting this requirement, typically address only the material weaknesses reported by the auditors. The letters are silent on the significant deficiencies reported by the auditors, even if there are numerous significant deficiencies, the significant deficiencies have existed for several years, and/or the significant deficiencies represent material weaknesses that have been downgraded as a result of negotiation as much as improvements in the controls.

OMB Circular A-136 should be clarified to assure that the Chief Financial Officer letters address both material weaknesses and significant deficiencies. As with problems in the internal control related to performance measures, one could state that there should not be a requirement to address the significant deficiencies because it results in the problems in areas of lesser importance. A more responsible position is to recognize and accept that significant deficiencies could be a portent of a deteriorating situation that could become a material weakness.

**Direct that the Forward-Looking Information Address Critical Matters.** As stated, OMB Circular A-136 separated the guidance for preparing an AFR's MD&A into two parts: Section II.1.3, which overviewed what an AFR must contain; and Section II.2 for "an outline of the required information to be included in the MD&A." The latter identified the major portion of what should be presented in the MD&A in a bullet list, and then added—almost as an afterthought—that the MD&A "should also include forward-looking information about the possible effects of the most important existing performance and financial demands, events, conditions, and trends," "may include forward-looking information about the possible effects of the most important anticipated performance and financial demands, events, conditions, and trends," and "should discuss important problems that need to be addressed, and actions that have been planned or taken to address those problems."

Forward-looking information and what the agencies plan to do to address known and possible significant demands, events, conditions and trends could well be the most important information for the report to convey. However, one result of bifurcating and deemphasizing the guidance is that only five agencies presented information that they felt concerned future challenges. And of those, one concluded that the strides it made in the past was the way to present forward-looking information. A second assumed it had to describe its strategies for addressing the most serious management and performance challenges identified by the IG and Government Accountability Office (GAO), and didn't even address an extremely significant existing and future condition facing the nation in which the department has a major role.

Another clarification to OMB Circular A-136 should be to stress the importance of presenting information about matters within the agency's area of responsibility that could affect the country and its citizens in the future, possibly adversely, and what the agency will do to offset the impact of these conditions. The guidance should indicate that the fo-

cus of this presentation is to be on matters other than the management challenges identified by the IG, whose impact is mostly internal. It should also indicate that when applicable, the financial and financial management implications of the forward-looking matters should be addressed.

**Streamline the Reporting of Management and Performance Challenges.** Related to the prior recommendation is the manner in which the reports presented the summaries of the most serious management and performance challenges identified by the IGs. As reported in Figure 2, all nine included in the summaries the required assessment of management's progress addressing the challenges. In five reports, however, management presented its own description of progress. In fact, in one report, management presented its description prior to the IG's summary, and thus before readers had an opportunity to read and understand the challenges. This information added, unnecessarily, to the length of the MD&A.

OMB Circular A-136 should remind the agencies that the summaries of progress addressing the most serious management and performance challenges should be presented by the IGs, not management. Management should be encouraged to work with the IGs in order that the assessments are complete. The addition of a separate management response to the IG's summary of challenges would be warranted only if the IG's assessment is incomplete.

Advantages include shortening the report, eliminating inconsistencies, and avoiding the appearance of defensiveness on the part of management. Finally, progress described by the IG is generally considered more objective than progress described by management.

Another recommendation is that OMB Circular A-136 should indicate that the statute requires a summary of the challenges and the agency's progress addressing the challenges. The IGs should avoid presenting their past, present, and planned work in respect of the challenges. This practice needlessly shifts the readers' attention from the agency's performance to the IG's performance.

**Clarify the Reporting of Improper Payments Information.** Improper Payments Information Act information was reported as other accompanying information in all nine Pilot Program reports, although five reports also summarized the information in the MD&A and referred readers to the OAI (or appendices) for additional information. The inconsistencies, which were even more pronounced within the OAI presentations, were probably because not all agencies have programs susceptible to significant improper payments.

Perhaps the most sensible approach is for OMB Circular A-136 to direct agencies that operate programs with an undesirable level of improper payments to list in the MD&A the programs susceptible to improper payments and refer the reader to the OAI to ascertain, program-by-program, the agency's risk assessments, statistical sampling approaches, planned corrective action plans, improper payments reduction outlooks, etc. Agencies with programs that do not have an undesirable level of improper payments would simply state that in the MD&A and not provide further information.

**Encourage Comprehensive Reviews of the Reports and Use the Review Feedback for Improvement.** The Reports Consolidation Act and OMB Circular A-136 requirements for annual accountability and performance reporting are extensive. The resulting reports are the major, if not the only, process used by the agencies to pull together and report the many elements of financial and performance management. A properly done process can provide the agencies with major benefits, plus contribute to the improvement of the government's overall management.

OMB reviews the submitted reports 10 days prior to their required issuance. Assumedly, this review is for the purpose of assuring they are consistent with administration policies. With limited resources, the reports are generally not reviewed by OMB for adherence to the requirements to provide the desired information, for transparency, for readability, for organization, for excessive redundancy; in short, for quality.

Fortunately, external groups are willing and able to review the agencies' reports of accountability and performance—AGA and Mercatus Center at George Mason University, for example. Assuming that these reviews are to improve usefulness, and not just for non-compliance, and in the absence of the resources to review the agencies' reports directly, OMB should encourage agencies to have their reports reviewed, after issuance, by an independent entity. OMB should request copies of the external review findings from the agencies and, if it believes the reviews are unbiased and have been conducted by qualified individuals, hold the agencies accountable for addressing the review findings and recommendations with which OMB agrees.

### **Recommendations for the Citizens' Report and the Annual Performance Report**

The following two recommendations pertain to the Citizens' Report and the APR. Although AGA's evaluation was limited to the AFR, we believe these two actions would also strengthen the agencies' ability to meet the reporting objectives.

**Identify the Audiences for the Citizens' Report and Develop Those Reports Accordingly.** The Citizens' Report is limited to 25 pages. But even a report of 25 pages is too long for the average citizen. Americans get their information from sound bites and web sites.

Furthermore, the audiences and purposes for a Citizens' Report are likely to differ among agencies. For instance, it has been reported that the primary audience and purpose for the Citizens' Report of the:

Department of State are the overseas-based ambassadors and their staffs, who use the report to inform foreign nationals about the U.S. government and what it does;

National Science Foundation are scientists and academicians to whom NSF wants to describe its programs, and thereby stimulate grant applications; and

Government Accountability Office are members of Congress and their staffs who want to know that GAO is addressing their interests.

While a Citizens' Report can be a good "general interest report," each agency should define as explicitly as possible the audience for whom the Citizens' Report is to be written, what purpose would be served by a Citizens' Report, how the members of this audience normally get information, and then shape the report accordingly. If it is not going to be the average citizen, consideration should be given to whether "Citizens' Report" is a misleading title and should be changed.

An agency's definition of the audience, purpose and method of obtaining information for its Citizens' Report might lead to decisions to produce an even smaller report, for example, the pocket-sized foldout prepared by the Department of State; and/or to send e-mails to members of already-established lists to distribute the report.

**Increase the Likelihood the Performance Information Will Be Used.** Performance information is generally used in the executive branch to inform the budget preparation process. One of the reasons OMB decided to make the issuance of the APR simultaneous with submission of the Congressional Budget Justification is to increase the likelihood that the performance information would be used in congressional budget deliberations.

Congress has been generally reluctant to consider performance information during budget deliberations. Some believe the political nature of budget decisions makes performance information extraneous. Others feel members of Congress and their staffs do not understand performance information.

Considering that the APR will now be delivered to the Congress along with the Congressional Budget Justification, agencies have an opportunity and an obligation to provide to their Authorizing Committees' and Appropriations Subcommittees' members and staffs with an understanding of and appreciation for what the performance information is and reveals. OMB should encourage the agencies to take this extra step.

## **CONCLUSION**

AGA has evaluated OMB's Pilot Program approach and concluded that it provides the basis for furthering transparency and accountability. But financial reporting is only one part of financial management, much less management in general. Financial management enables an organization to be accountable for its financial position and results. It also stimulates the establishment and maintenance of information systems, increases an organization's insight into its own operations, improves the reliability of information, enhances the effectiveness of internal controls, and provides information for decision-making.

A major other aspect of good management is achieving intended results, that is, performance. The PARs demonstrated accountability for that aspect of management as well. Although the Pilot Program has separated the two aspects of accountability, in its entirety

the Pilot Program approach has the potential to correct the deficiencies that arose in the PARs, namely unwieldy size, excessive time to prepare, a lack of relevance to the congressional budget process.

Achieving that potential will require that several additional steps be taken, many of which are discussed above. Some of these steps involve the AFR; still others require adjustments to the other parts of the Pilot Program, namely the APR and the Citizens' Report. All should be taken.

PILOT PROGRAM AND NON-PROGRAM PILOT AGENCY  
REPORTS REVIEWED

**PILOT PROGRAM AGENCIES  
AGENCY FINANCIAL REPORTS REVIEWED<sup>4</sup>**

Department of Defense  
Department of Energy  
Department of Health and Human Services  
Department of Homeland Security  
Department of State  
Agency for International Development  
National Aeronautics and Space Administration  
National Science Foundation  
Small Business Administration

**NON-PILOT PROGRAM AGENCIES  
PERFORMANCE AND ACCOUNTABILITY REPORTS REVIEWED**

Department of Agriculture  
Department of Commerce  
Department of Education  
Department of Housing and Urban Development  
Department of the Interior  
Department of Labor  
Department of Treasury  
General Services Administration  
Nuclear Regulatory Commission  
Office of Personnel Management  
Social Security Administration

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<sup>4</sup> Two non-CFO Act agencies also participated in the Pilot Program and prepared AFRs: Denali Commission and National Community Service Corporation. They are not included in the subsequent analysis.

RESULTS OF THE REVIEWS OF THE NINE PILOT PROGRAM AGENCY  
AGENCY FINANCIAL REPORTS

**Size of the Agency Financial Reports.** The size of the AFRs are considerably smaller than the size of the Performance and Accountability Reports (PARs). **All but two** ranged between 110 and 150 pages; **one** is 222 pages, and **one** is 338 pages. By comparison, the 12 PARs reviewed ranged between 171 and 444 pages, with an average length of 288 pages.

**Message of Participation in the Pilot Program.** All **nine** AFRs identified that the agency is participating in the Pilot Program on the inside front cover, agency head message, MD&A, message from the Chief Financial Officer or several places. All **nine** also identified the time and location for obtaining the APR, but only **seven** stated how the alternative approach would improve performance reporting.

**Organization of the Agency Financial Reports.** The AFRs generally complied with the OMB guidance for inclusion of an agency head message and three sections—MD&A, Financial Section and OAI. There were the typical variations. **Two** AFRs did not include an OAI. The information required for that section was presented as an appendix, in a separate standalone section, or not at all.

Some of the reports also contained a foreword, preface, how-to-use the report section and/or executive summary

**Electronic Versions of the Agency Financial Reports.** **Six** AFRs identified the agency's electronic home page, all on the back cover, with some also identifying it elsewhere.

**Seven** agencies advised that the AFR is available on the Internet and provided the Internet address, generally on an inside cover. **One** AFR listed the report's Internet address on the Table of Contents page, but did not identify what the address represented.

In only **one** instance did the presented address take the user directly to the electronic version of the report. Typically, two or three clicks were required.

The electronic version of the AFR could also be reached from the agency's home page through a clearly visible notation for **seven** of the nine reports, and through the search box for **eight** of the nine reports. Again, two to three clicks were required.

**Five** of the electronic versions of the AFRs were presented in a single file; **eight** in multiple files; **four** were presented both ways.

At least **two** agencies also provided a CD-ROM containing the AFR.

**Readability and Related Elements.** The AFRs generally used the same presentation techniques to enhance readability that are used in the PARs. **All but two** used colors, **all but one** included tables, graphs and pictures, although in **one** the only pictures were of the agency head and the Chief Financial Officer.

Also contributing to readability were color coding the page headers or edges to facilitate locating materials (**two** reports); picture-accompanied vignettes of how the agency fulfilled its mission and served the American people (**two** reports); and adding to the title page for each section a brief description of the section's contents (**one** report).

**Eight** of the nine AFRs provided a glossary to help readers understand the terminology.

**Three** AFRs acknowledged, by name, organizations and individuals that contributed to the reports' preparation.

**Seven** AFRs requested comments for improving the report and provided an address to which the comments should be sent.

**Agency Head Messages.** As stated, all **nine** AFRs contained a message from the agency head, although one was from the deputy agency head. All **nine** were dated. **All but one** acknowledged that the agency was participating in the Pilot Program and issuing alternative reports.

Only **four** agency head messages presented the agency's goals, with **one** presenting the agency's mission.

All **nine** messages presented the agency's significant achievements, although one presented achievements for only one aspect of the agency's mission. The other major aspect was not addressed. The messages, however, tended to be one-dimensional, due to an absence of information concerning problems, challenges and other issues.

Only **six** of the messages presented the required assessment of the completeness and reliability of financial and performance data in the report. **Four** stated the data were complete and reliable and **one** provided the assurance for the performance data, but not the financial data. The **two** agencies that identified inadequacies did not identify the actions the agency is taking to resolve the inadequacies (or reference a more detailed discussion of this topic elsewhere in the report).

**Five** of the messages provided assurance on internal control (even though it was also provided in the report's MD&A).

**Five** mentioned the results of the financial audit, and **two** mentioned there were no auditor-determined internal control material weaknesses—representing the five agencies that received clean audit opinions. There was no mention of the financial audit results by the four agency heads whose agencies received other than a clean audit opinion.

**Management’s Discussion and Analysis—Overall.** The Pilot Program instructions restricted the length of the agency head message and the MD&A to 30 pages. **Seven** complied with the restriction; two did not. However, **seven** of the reports presented as OAI or in the appendices or other sections of the report anywhere from one to 15 pages of information readers would expect to find in the MD&A, for example, organization chart, status in regard to the Federal Financial Management Improvement Act and Federal Information Security Management Act, list of strategic goals and multi-year outcomes. If these pages are included, **one** additional report exceeded the 30-page limit.

**Management’s Discussion and Analysis—Acknowledgement of Alternative Format.** The MD&As in **six** of the nine reports included paragraphs acknowledging the agency’s use of the alternative to the consolidated PAR. (The three that did not included the acknowledgement in the agency head message or elsewhere in the report.) The **six** provided the Internet address for the APR, advised that the agency would be issuing a highlights document in February, and provided the Internet address for the highlights document.

**Management’s Discussion and Analysis—Mission and Organization Structure.** All **nine** presented the agency’s mission (although in one, it was on the inside front cover; and in another, it was in a box preceding the agency head message). **Six** MD&As contained a description of the agency’s organization structure. **Seven** presented an organization chart. (**One** presented its organization chart as an appendix.)

**Management’s Discussion and Analysis—High-level Discussion of Performance Information.** Performance information in the AFR is intended to be limited—and might have been required by OMB only to ensure compliance with the requirements of Statement of Federal Financial Accounting Standards No. 15 *Management’s Discussion and Analysis*. This standard requires that a MD&A address the entity’s performance goals, objectives and results. Hence, **most** of the reports dedicated no more than four pages to performance information, with **one** report limiting the discussion to a half-page identification of the numbers of goals, objectives and targets, and directing the readers to the Internet for additional performance information. **Two** agencies dedicated 15 and 20 pages respectively.

**Seven** AFRs described the process and/or structure the agency uses to measure and report performance. All **nine** referenced the agency’s strategic plan and **six** provided the Internet address for viewing the strategic plan. **Eight** AFRs identified the agency’s strategic goals.

**Seven** AFRs presented selected accomplishments for each of the strategic goals. **Two** were more explicit; they presented performance results for selected, assumedly key, performance measures.

Only **two** AFRs identified in the MD&A the resources expended for each strategic goal. **Zero** AFRs presented results for any efficiency measures. This is ironic. **Six** of the nine agencies presented in the Statement of Net Cost or the footnotes to the financial statements the costs incurred for each strategic goal identified in the MD&A.

**Four** AFRs addressed the process for verifying and validating the performance information.

Finally, **four** MD&As presented the results of the PART assessments completed for the agency's programs. They also referenced the readers to [expectmore.gov](http://expectmore.gov) to obtain additional information about the PART program and performance of the agency's programs.

**Management's Discussion and Analysis—Analysis of Financial Statements.** All **nine** MD&As included a section analyzing the financial statements. All **nine** identified the significant amounts in the agency's financial statements and explained, to a limited degree, the relevance of the amounts to particular financial management issues. **All but one** identified and explained the significant year-to-year changes in the financial statements. However, the explanations were mostly an identification of the accounts that caused the changes. This type of analysis provided little information beyond that already presented in the financial statements. The analysis in **seven** reports provided information about the sources and uses of budget resources. **Five** AFRs reiterated the results of the audit of the financial statements. **All but two** of the AFRs used graphs to present the analysis.

**Management's Discussion and Analysis—Analysis of Systems, Controls and Legal Compliance.** All **nine** MD&As included a section on systems, controls and legal compliance. The section included the agency head's assurance on Sections 2 and 4 of the Federal Managers' Financial Integrity Act and Appendix A of OMB Circular A-123. **Four** of the assurance letters also addressed the agency's compliance with the Federal Financial Management Improvement Act.

In **seven** AFRs, the section described the agency's internal control process. **Two** AFRs listed the criteria the agency uses to report a material weakness in internal control.

**Six** of the agencies reported material weaknesses in internal control. **Four** reports presented the corrective action plans with the estimated completion date for each weakness. **One** presented just the estimated completion dates, but without the plans.

**Nine** AFRs described the status of the compliance with the Federal Financial Management Improvement Act; **two** with the Federal Information Security Management Act. **Three** AFRs described the plans for the agency's financial systems in the MD&A; **three** more discussed the plans in the Financial Section or OAI.

**Management's Discussion and Analysis—Forward-looking Information** **Five** MD&As included a forward-looking information section using such titles as Leadership Challenges, Looking Forward, etc., although one addressed only the accomplishments of past challenges and said nothing about future challenges. Only **one** AFR described the financial implications of the challenges.

**Management’s Discussion and Analysis—Limitations of the Financial Statements.** **Seven** MD&As included the statement concerning the limitations of the financial statements. (**One** agency included the statement in the report’s Financial Section.)

**Management’s Discussion and Analysis—Other.** Examples of other materials presented by individual agencies in their MD&As were a list of an agency’s values, a discussion of future business trends and events, grants management processes, and the corrective action plans and target completion dates for auditor-determined significant deficiencies (as opposed to Federal Managers’ Financial Integrity Act material weaknesses).

**Five** agencies summarized their status in regard to the requirements of the Improper Payments Information Act and referred the reader to the OAI for additional information concerning improper payments.

**Six** of the MD&As addressed the President’s Management Agenda and identified the agency’s progress and status, as of Sept. 30, 2007, for the five original initiatives plus other recently added initiatives. **Two** presented the status for prior years as well. **One** agency described its accomplishments for each of the initiatives and **one** described its plans. **Three** agencies referred readers to results.gov to obtain additional information about the President’s Management Agenda.

**Financial Section—Chief Financial Officer Letter.** All **nine** AFRs contained a dated letter from the Chief Financial Officer (although one letter appeared immediately following the agency head message rather than in the Financial Section). **Eight** cited the results of the financial audit (the “non-citer” received a disclaimer of opinion for its audit). **Three** presented the planned time frames for correcting audit weaknesses and noncompliances; **one** that had no material weaknesses presented the information for its auditor-reported significant deficiencies. Three agencies had no audit weaknesses, which means that two agencies did not provide the required information. **Two** reported major impediments to correcting the audit weaknesses and noncompliances. **Five** reported the progress made correcting previously reported weaknesses.

All **nine** AFRs described the agency’s financial management accomplishments, with **six** reporting the status of their financial management systems.

**Financial Section—Financial Statements and Auditors’ Report.** All **nine** AFRs contained the required audited financial statements. The reports indicated that **one** agency issued its financial statements as early as Nov. 9, and only **one** issued as late as Nov. 15. The other **seven** issued their financial statements between Nov. 10 and 14.

**Two** of the audits were performed by the agency’s Inspector General (IG); **five** by an external “Final Four” audit firm; and **two** by firms other than the “Final Four.”

**Seven** of the reports presented the auditors’ letter prior to the financial statements; **two** after the financial statements. **One** report also included an auditors’ opinion on the agency’s internal control over financial reporting, probably because the opinion is man-

dated by statute. **One** agency's report included a letter from the agency's audit committee.

The major change in the auditors' reports was the elimination of the auditors' assurance on the reliability of at least a portion of the agency's performance information. Specifically, the auditor of an agency's financial statements is required to obtain an understanding of the existence and completeness assertions relevant to the performance measures included in the MD&A, and report those internal controls that have not been properly designed and placed in operation. Although this requirement was in existence for 2007, only **five** auditors reviewed the underlying controls and provided the assurance. Since some Pilot Program agencies did not include explicit performance results in the "high-level discussion of performance information" presented in the MD&As, the auditors of those agencies concluded the requirement to review the internal controls underlying the performance measures was moot and did not provide the assurance in the auditors' report.

**Other Accompanying Information—Management and Performance Challenges.** All **nine** AFRs presented a summary of the IG's most serious management and performance challenges, although **one** presented the summary as a standalone section and one presented the summary as an appendix. Only **six** reports identified the summary as the IG's, and one of those did so only in the text, not the Table of Contents. **Eight** reports listed and identified the location of the summary in the Table of Contents.

The nine agencies presented a total of 63 serious management and performance challenges. The number identified for each agency ranged between five and 10, with the average being seven. The information was presented in three to 32 pages, which means the average challenge was summarized in slightly less than two pages, although the range was one-half page per challenge to three and one-half pages.

The nature of the 63 challenges for the nine agencies was as follows: Program-related-31; IT Security-6; Financial Management-5; Human Capital-5; Procurement and Inventory-5; IT-3; GPR-2; Management Control-1; Other Management-5.

All **nine** summaries included the required assessment of management's progress addressing the challenges. However, in **five** reports, management presented its own comments regarding the challenges (although for one, the comments described the agency's progress addressing the prior year's challenges and these challenges were generally the same as the current year's). In **one** report, management's comments were presented in the MD&A, prior to the IG's summary, that is, before readers would have an opportunity to read and understand the challenges.

**Four** of the summaries also described the IG's past, present and planned work in respect of the challenges. Although this information might be informative, it drew the readers' attention away from the agency's performance and placed the focus on the IG's performance.

**Other Accompanying Information—Summary of Financial Statement Audit and Management Assurances.** Seven agencies presented as Other Accompanying Information, the required Summary of Financial Statement Audit and Management Assurances; **one** presented it as an appendix. The **eight** presented the information in a table that provided the information for financial audit material weaknesses, internal control over financial reporting material weaknesses, Federal Managers’ Financial Integrity Act material weaknesses, Federal Managers’ Financial Integrity Act non-compliances and Federal Financial Management Improvement Act non-compliances. The terms used to multiply the material weaknesses and non-compliances were both short and consistent.

**Other Accompanying Information—Improper Payments Information Act Reporting Details.** Seven agencies presented as other accompanying information, the required Improper Payments Information Act details; **two** presented the information as an appendix, including an agency that received permission from OMB to not have to report the information every year. The number of high risk programs reported on per agency ranged between one and 15, with one agency, which did not have any high-risk programs, presenting the information for its vendor contracts, payroll, travel and similar expenses.

There was considerable inconsistency in how the reporting requirements were fulfilled. **Six** of the nine presented the results of risk assessments; **seven** presented their statistical sampling approaches; **six** presented corrective action plans to prevent/reduce improper payments, with only **one** presenting what has been accomplished in funds stewardship past the primary recipient; **eight** presented their improper payments reduction outlook; **six** described the steps to hold managers accountable for improper payments; **six** described the information systems and other infrastructure needs; and **five** described statutory or regulatory barriers that might limit the agency’s corrective actions. All **eight** presented the results of their recovery auditing efforts.

**Appendices.** Six AFRs also included appendices. In each instance, one of the appendices was a glossary of acronyms appearing in the report. Other appendices, besides providing the IG’s summary of the most serious management and performance challenges and the Improper Payments Information Act Details, presented such material as Internet links, the agency’s actions in response to OMB evaluations, and Circular A-123 definitions and reporting requirements.