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The President
The President of the Senate
The Speaker of the House of Representatives

Given the federal government's near- and long-term fiscal challenges, the need for transparency and for the Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information is greater than ever. As our report on the U.S. government's consolidated financial statements illustrates, however, even though certain progress has been made, much work remains to improve federal financial management. Consequently, financial management needs to be a top priority of this administration and the Congress.

The economic recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery have significantly affected the federal government's financial condition. The resulting substantial investments and increases in liabilities, net operating cost, the unified budget deficit, and debt held by the public are reported in the U.S. government's consolidated financial statements for fiscal year 2009. Because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions, actual results may be materially different from the reported amounts. Further, the ultimate cost of these actions and their impact on the federal government's financial condition will not be known for some time. More significantly, the federal government faces long-term challenges resulting from large and growing structural deficits that are driven primarily by rising health care costs and known demographic trends. This unsustainable path must be addressed soon by policymakers. The longer actions are delayed, the more difficult adjustments are likely to become.

Our report on the U.S. government's consolidated financial statements is enclosed. In summary, we found the following:

- Certain material weaknesses in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that prevented us from expressing an opinion on the fiscal year 2009 and 2008 financial statements other than the Statements of Social Insurance. About $906 billion, or 34 percent, of the federal government's reported total assets as of September 30, 2009, and approximately $784 billion, or 23 percent, of the federal government's reported net cost for fiscal year 2009 relate to four agencies' fiscal year 2009 financial statements that as of the date of our report, received disclaimers of opinion or were not audited.[1]

- The 2009, 2008, and 2007 Statements of Social Insurance are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.[2] Given the importance of social insurance programs to the federal government's long-term fiscal outlook, the Statement of Social Insurance is critical to understanding the federal government's financial condition and fiscal sustainability.

- Material weaknesses resulted in ineffective internal control over financial reporting (including safeguarding of assets).

- Our work to test compliance with selected provisions of laws and regulations in fiscal year 2009 was limited by the material weaknesses and other scope limitations discussed in our report.

While significant progress has been made in improving federal financial management since the federal government began preparing consolidated financial statements years ago, three major impediments continued to prevent us from rendering an opinion on the federal government's accrual-based consolidated financial statements over this period of time[3]: (1) serious financial management problems at the Department of Defense (DOD) that have prevented DOD's financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. In addition, the financial statements of the Department of Homeland Security and the National Aeronautics and Space Administration for fiscal years 2009 and 2008 were not auditable or were not subjected to audit by agency auditors.

[1]Of the 24 Chief Financial Officers Act agencies, the agencies that, as of the date of our report, received disclaimers of opinions on all of their fiscal year 2009 financial statements were the Department of Defense and the National Aeronautics and Space Administration. For the Department of Homeland Security for fiscal year 2009, only the Consolidated Balance Sheet and the Statement of Custodial Activity were subjected to audit; the auditor was unable to express an opinion on these two financial statements. In addition, the auditor of the Department of State's (State) fiscal year 2009 financial statements was unable to obtain sufficient evidential support for property and equipment amounts presented in State's fiscal year 2009 financial statements.

[2]Beginning in fiscal year 2006, the Statement of Social Insurance became a principal financial statement and was audited as part of the applicable federal agencies' financial statements. We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance.

[3]The accrual-based consolidated financial statements for the fiscal years ended September 30, 2009 and 2008, consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. The 2009, 2008, 2007, and 2006 Statements of Social Insurance, including the related notes, are also included in the consolidated financial statements. The Statements of Social Insurance do not interrelate with the accrual-based consolidated financial statements.

In addition to the material weaknesses underlying these major impediments, we noted three material weaknesses involving the federal government’s inability to (1) determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments, currently estimated to be at least $98 billion; (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis; and (3) effectively manage its tax collection activities. Until the problems outlined in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

The material weaknesses discussed in our report continued to

- hamper the federal government’s ability to reliably report a significant portion of its assets, liabilities, costs, and other related information;
- affect the federal government’s ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities;
- impair the federal government’s ability to adequately safeguard significant assets and properly record various transactions; and
- hinder the federal government from having reliable financial information to operate in an efficient and effective manner.

The federal government reported a net operating cost of $1.3 trillion and a unified budget deficit of $1.4 trillion for fiscal year 2009, significantly higher than the amounts in fiscal year 2008. As of September 30, 2009, debt held by the public increased to 53 percent of gross domestic product (GDP). These increases are primarily the result of the effects of the recession and the costs of the federal government’s actions to stabilize the financial markets and to promote economic recovery.

In December 2007, the United States entered what has turned out to be its deepest recession since the end of World War II. Between the fourth quarter of 2007 and the third quarter of 2009, GDP fell by about 2.8 percent. The nation’s unemployment rate rose from 4.9 percent in 2007 to 10.2 percent in October 2009, a level not seen since April 1983. Federal tax revenues automatically decline when GDP and incomes fall, and at the same time, spending on unemployment benefits and other income-support programs automatically increases.

As of September 30, 2009, the federal government’s actions to stabilize the financial markets and to promote economic recovery resulted in an increase in reported federal assets of over $500 billion (e.g., the Troubled Asset Relief Program (TARP) equity investments, and investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and mortgage-backed securities guaranteed by them), which is net of about $80 billion in valuation losses. In addition, the federal government reported incurring additional significant liabilities (e.g., liquidity guarantees to Fannie Mae and Freddie Mac) and related net cost resulting from these actions. Because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions, actual results may be materially different from the reported amounts. For example, assets and liabilities subject to substantial uncertainty include the following:

- The U.S. government’s consolidated financial statements for fiscal year 2009 include approximately $65 billion of investments in Fannie Mae and Freddie Mac (net of about $38 billion in valuation losses), about $92 billion of liabilities for future payments under liquidity guarantees with these entities, and about $126 billion of related net cost. The statements also discuss an estimated additional liability and net cost of about $130 billion related to these guarantees that could be incurred under an “extreme case” scenario, based on the estimates as of September 30, 2009. Also, these estimates could be affected by the Department of the Treasury agreement, subsequent to September 30, 2009, to increase, as necessary, its liquidity guarantees to Fannie Mae and Freddie Mac to accommodate any cumulative reduction in the net worth of these two entities over the next 3 years.

- The federal government reported TARP direct loans and equity investments of approximately $238 billion as of September 30, 2009 (net of about $53 billion in valuation losses, including $30 billion related to American International Group, Inc. (AIG) and $31 billion related to loans to and equity investments in certain entities in the automotive industry, including General Motors and Chrysler, partially offset by valuation gains of $8 billion primarily related to investments in financial institutions).

- The federal government reported Federal Deposit Insurance Corporation (FDIC) liabilities of $59 billion as of September 30, 2009, and about $45 billion of net cost related to estimated failures of insured financial institutions, guarantees, and bank resolutions. These liabilities and cost resulted in a negative reported ratio of reserves to estimated insured deposits in FDIC’s Deposit Insurance Fund (DIF), far below the statutory minimum of 1.15 percent. FDIC recently reported additional losses incurred by the DIF from actual and anticipated financial institution failures and resolution activity through December 31, 2009, resulting in a further increase in DIF’s negative reported ratio of reserves to estimated insured deposits. FDIC has implemented a restoration plan to replenish the DIF’s reserves to the statutory minimum. Further losses could occur if potentially vulnerable insured institutions ultimately fail, guarantees result in greater than anticipated losses, or economic and market conditions further deteriorate.

- Further deterioration in the residential real estate market could result in additional losses for the Federal Housing Administration (FHA) beyond the reported loan guarantee liability of about $34 billion as of September 30, 2009. During fiscal year 2009, FHA’s guaranteed loan principal amount outstanding increased by about 42 percent compared to the amount in fiscal year 2008.

In addition, the federal government's financial condition will be further affected as its actions continue to be implemented in fiscal year 2010 and later. For example, several hundred billion dollars of the total estimated $862 billion cost under the American Recovery and Reinvestment Act of 2009 (Recovery Act)[4] remain to be disbursed.[5] Also, continued implementation of TARP, [6] which was extended through October 3, 2010, is likely to result in additional cost, and the FHA mortgage guarantee program could result in additional cost. Consequently, the ultimate cost of the federal government's actions and their effect on the federal government's financial condition will not be known for some time.

Further, there are risks that the federal government's financial condition could be affected in the future by other factors, including the following:

- Several initiatives undertaken in 2009 by the Federal Reserve to stabilize the financial markets have led to a significant change in the reported composition and size of the Federal Reserve's balance sheet, including the purchase of over $900 billion in mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association as of the end of 2009. If the Federal Reserve sells these securities at a loss, additional federal government deposits at the Federal Reserve may be needed, future payments of Federal Reserve earnings to the federal government may be reduced, or both.[7]

- Although the Recovery Act provided some fiscal relief to the states, expected continued state fiscal challenges could place pressure on the federal government to provide further relief to them.

Looking ahead, the federal government will need to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. In addition to managing these actions, problems in the nation's financial sector have exposed serious weaknesses in the current U.S. financial regulatory system, which, if not effectively addressed, may cause the system to fail to prevent similar or even worse crises in the future. The current system, which was put into place over the past 150 years, is fragmented and complex and simply has not kept pace with the major financial structures, innovations, and products that emerged during the years

[4]Pub. L. 111-5, 123 Stat. 115 (Feb. 17, 2009).
[5]Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (Washington, D.C., January 2010).
[6]GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, GAO-10-301 (Washington, D.C.: Dec. 9, 2009).
[7]Under Federal Reserve System policy, Federal Reserve bank earnings in excess of statutory dividends to member banks are paid to the federal government. The federal government received about $34 billion of such payments in fiscal year 2009.

leading up to the recent financial crisis. Consequently, meaningful financial regulatory reform is of utmost concern.[8]

The federal government faces even larger fiscal challenges in the long term. As discussed in this *2009 Financial Report of the United States Government* (*Financial Report*), the federal government is on an unsustainable long-term fiscal path driven primarily by rising health care costs and known demographic trends. The Statement of Social Insurance, for example, shows that the present value of projected scheduled benefits exceeds earmarked revenues for social insurance programs (e.g., Social Security and Medicare) by about $46 trillion over the next 75-year period.[9] In addition, our most recent long-term simulations for all federal government programs show that absent policy changes, debt held by the public as a percentage of GDP could exceed the historical high reached in the aftermath of World War II in a little over 10 years.[10] Absent a change in policy, under this scenario, the interest costs on the growing debt together with spending on major entitlement programs could absorb 92 cents of every dollar of federal revenue in 2019.[11] Clearly, this is not sustainable.

Accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability for the federal government's operations, financial condition, and fiscal outlook. New financial reporting standards will require fiscal sustainability reporting in the federal government's financial statements beginning in fiscal year 2010. Such reporting will include clear and transparent information about the long-term fiscal condition of the federal government and annual changes therein, and will expand upon the information currently provided in the Management's Discussion and Analysis section of the *Financial Report*. Our nation's leaders need a clear and realistic assessment of the federal government's financial condition to address the long-term challenges that lie ahead.

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[8]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System,* GAO-09-216 (Washington, D.C.: Jan. 8, 2009). Our report describes the nine characteristics that should be included in any new regulatory system: (1) clearly defined regulatory goals; (2) appropriately comprehensive; (3) systemwide focus; (4) flexible and adaptive; (5) efficient and effective; (6) consistent consumer and investor protection; (7) regulators provided with independence, prominence, authority, and accountability; (8) consistent financial oversight; and (9) minimal taxpayer exposure.

[9]On an open group basis (current and future participants).

[10]GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2009 Update*, GAO-10-137SP (Washington, D.C.: October 2009). These simulations will be updated in a report forthcoming in early March 2010.

[11]GAO's Fall 2009 alternative simulation is based on the 2009 Trustees' assumptions for Social Security and Medicare. Discretionary spending other than the Recovery Act provisions grows with GDP after 2009; and the Recovery Act provisions are included but assumed to be temporary. Expiring tax provisions are extended and the Alternative Minimum Tax exemption amount is indexed to inflation through 2019. After 2019, revenue as a share of GDP is brought to its 40-year historical average of 18.3 percent of GDP. Medicare spending is adjusted based on the assumption that physician payments are not reduced as specified under current law.

In addition, there is a continuing need to (1) consider whether any further changes are needed in the federal reporting model to more effectively meet the needs of agency management, policymakers, the Congress, and the public and (2) develop a combined report on the performance and financial accountability of the federal government as a whole. This report could include, among other things, key outcome-based national indicators (e.g., economic, security, social, and environmental), which could be used to help assess the nation's and other governmental jurisdictions' position and progress.

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Our report on the U.S. government's consolidated financial statements would not be possible without the commitment and professionalism of inspectors general throughout the federal government who are responsible for annually auditing the financial statements of individual federal entities. We also appreciate the cooperation and assistance of Department of the Treasury and Office of Management and Budget officials as well as the federal entities' chief financial officers. We look forward to continuing to work with these individuals, the administration, and the Congress to achieve the goals and objectives of federal financial management reform.

Our audit report begins on page 209. Our guide[12] to the *Financial Report of the United States Government* is intended to help those who seek to obtain a better understanding of the *Financial Report.* In addition, our guide[13] entitled *Understanding Similarities and Differences between Accrual and Cash Deficits* provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time. These guides are available on GAO's Web site at www.gao.gov.

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[12]GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005). In September 2009, we issued an update to this guide to reflect recent changes to the federal accounting standards and resulting changes to the *Financial Report*; see GAO-09-946SP (Washington, D.C.: September 2009).
[13]GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006). In January 2007 and 2008, we issued updates to this guide for fiscal years 2006 and 2007; see GAO-07-341SP (Washington, D.C.: January 2007) and GAO-08-410SP (Washington, D.C.: January 2008).

Our report was prepared under the direction of Robert F. Dacey, Chief Accountant, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-3406.

Gene L. Dodaro
Acting Comptroller General
of the United States

cc: The Majority Leader of the Senate
The Minority Leader of the Senate
The Majority Leader of the House
The Minority Leader of the House

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