Testimony
Before the Subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

FISCAL YEAR 2006
U.S. GOVERNMENT
FINANCIAL STATEMENTS

Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation’s Accountability and Fiscal Stewardship Challenges

Statement of David M. Walker
Comptroller General of the United States
FISCAL YEAR 2006 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation’s Accountability and Fiscal Stewardship Challenges

What GAO Found

For the 10th consecutive year, certain material weaknesses in financial reporting and other limitations on the scope of GAO’s work resulted in conditions that continued to prevent GAO from being able to provide Congress and the American people an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. While over the past 10 years significant progress has been made in improving financial management since the U.S. government began preparing consolidated financial statements, three major impediments continue to prevent GAO from rendering an opinion on the consolidated financial statements: (1) serious financial management problems at the Department of Defense, (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. Further, in GAO’s opinion, as of September 30, 2006, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations due to numerous material weaknesses.

From a broad federal financial management perspective, the federal government’s financial condition and fiscal outlook are worse than many may understand. The U.S. government’s total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total over $50 trillion, representing approximately four times the nation’s total output (GDP) in fiscal year 2006, up from about $20 trillion, or two times GDP in fiscal year 2000. The federal government faces large and growing structural deficits in the future due primarily to known demographic trends and rising health care costs. These structural deficits which are virtually certain given the design of our current programs and policies will mean escalating and ultimately unsustainable federal deficits and debt levels. Based on various measures and using reasonable assumptions the federal government’s current fiscal policy is unsustainable. Continuing on this imprudent and unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our domestic tranquility and national security. Tough choices by the President and the Congress are necessary in order to address the nation’s large and growing long-term fiscal imbalance.

The federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. While the current reporting model recognizes some of these needs, a broad reconsideration of issues such as the kind of information that may be relevant and useful for a sovereign nation, could stimulate needed discussion and lead to reporting enhancements that might help the Congress deliberate strategies to address the nation’s growing long-term fiscal imbalance. Furthermore, additional transparency in connection with federal budget reporting and legislative proposals is needed.
Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2006 and 2005. I would like to thank you for continuing the annual tradition of oversight hearings on this important subject. The involvement of your subcommittee remains critical to ultimately assuring the continued progress in the financial management area while enhancing public confidence in the federal government as a financial steward that is accountable for its finances. Such hearings play a vital role in ensuring that the federal government is held accountable to the American people. Our work was conducted in accordance with U.S. generally accepted government auditing standards.

Both the consolidated financial statements and our report on them are included in the fiscal year 2006 Financial Report of the United States Government (Financial Report). The most recent report was issued by the Department of the Treasury (Treasury) on December 15, 2006, and is available through GAO’s Internet site, at http://www.gao.gov/financial/fy2006financialreport.html, and Treasury’s Internet site, at http://www.fms.treas.gov/fr/06frusg/06frusg.pdf. I also would like to highlight a guide we issued in September 2005 titled Understanding the Primary Components of the Annual Financial Report of the United States Government,1 which was prepared to help those who seek to obtain a better understanding of the Financial Report. This guide can also be found on GAO’s Internet site at http://www.gao.gov/new.items/d05958sp.pdf.

Since the enactment of key financial management reforms, the federal government has made substantial progress in improving financial management activities and practices. Federal financial systems requirements have been developed and internal control has been strengthened. Nonetheless, as I recently testified before the Senate Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, the federal government still has a long way to go to address several principal challenges to fully

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realizing strong federal financial management. For the 10th consecutive year, certain material weaknesses in financial reporting and other limitations on the scope of our work resulted in conditions that continued to prevent us from being able to provide the Congress and the American people an opinion as to whether the consolidated financial statements of the U.S. government were fairly stated in conformity with U.S. generally accepted accounting principles (GAAP). Further, we also reported that the federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2006. Until the problems that I will discuss today and that are discussed in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

GAO’s audit report also included an emphasis paragraph for the 3rd consecutive year noting that the nation’s current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary to address the nation’s large and growing long-term fiscal imbalance. In fact, the federal government’s financial condition and fiscal outlook are worse than many may understand. The value of the federal government’s net social insurance commitments, liabilities, and other fiscal exposures is now reported at over $50 trillion, representing close to four times Gross Domestic Product (GDP) in fiscal year 2006 and up from about $20 trillion or two times GDP in 2000. One way to think about it is: if we wanted to put aside today enough to cover these promises, it would take about $440,000 per American household, up from $190,000 in 2000. As these numbers indicate, the federal government faces large and growing structural deficits primarily related to Medicare and other social insurance commitments. These structural deficits—which are virtually certain given the design of our current programs and policies—will mean escalating and ultimately unsustainable federal deficits and debt levels. Simply put, despite an almost 12 percent increase in federal revenues this year, our nation’s financial condition and long-term fiscal imbalance continue to deteriorate and are on an imprudent and unsustainable course.

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3A material weakness is a condition that precludes the entity’s internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.
In this testimony, I will discuss (1) the challenges posed by the federal government’s fiscal condition and my views on a possible way forward, including ideas for consideration to improve the transparency of long-term costs; (2) our continued concerns about restatements to prior year financial statements; (3) the major issues relating to the consolidated financial statements for fiscal years 2006 and 2005, including systems problems that continue to hinder federal agency accountability; and (4) the need for an improved federal financial reporting model. I will also describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements.

From a broad financial management perspective, the federal government’s deteriorating long-range financial condition and long-term fiscal imbalance are matters of increasing concern. We face large and growing structural deficits due primarily to known demographic trends and rising health care costs. There is a need to engage in a fundamental review, repriorization, and reengineering of the base of the government. Understanding and addressing the federal government’s financial condition and long-term fiscal imbalance are critical to maintain fiscal flexibility so that we can respond to current and emerging social, economic, and security challenges.

The Nation’s Fiscal Imbalance

The reported long-term fiscal outlook will be shaped largely by known demographic trends and rising health care costs. As the baby-boom generation retires, federal spending on current retirement and health care programs—Social Security, Medicare, and Medicaid—will grow dramatically. These programs represent $39 trillion of the $50 trillion long-term fiscal exposure. A range of other federal fiscal commitments,
some explicit and some representing implicit public expectations, also bind the nation’s fiscal future. Absent policy changes, a growing imbalance between expected federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt levels.

There are various ways to consider and assess the long-term fiscal outlook. In this regard, information included in the Financial Report, and other information and analyses, can be used to more fully understand the nation’s long-term fiscal outlook, including:

- the Statement of Social Insurance,
- major reported long-term fiscal exposures, and
- long-term fiscal simulations.

**Statement of Social Insurance**

The Statement of Social Insurance in the Financial Report displays the present value of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). For Social Security and Medicare alone, projected expenditures for scheduled benefits for the next 75 years exceed earmarked revenues (e.g., dedicated payroll taxes, premiums, and existing government bonds in the trust funds) for the same period by approximately $39 trillion in present value terms. Stated differently, one would need approximately $39 trillion invested today to deliver on the currently promised benefits not covered by earmarked revenues for the next 75 years. Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

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4Present value is the discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.
Table 1: Simplified Statement of Social Insurance as of January 1, 2006

<table>
<thead>
<tr>
<th></th>
<th>Social Security</th>
<th>Medicare Hospital Insurance (Part A)</th>
<th>Medicare Supplementary Medical Insurance – Part B</th>
<th>Medicare Supplementary Medical Insurance – Part D</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future revenue (earmarked contributions, taxes, and premiums)</td>
<td>$32</td>
<td>$11</td>
<td>$5</td>
<td>$2</td>
<td>$50</td>
</tr>
<tr>
<td>Present value of expenditures for scheduled future benefits(^a)</td>
<td>(39)</td>
<td>(22)</td>
<td>(18)</td>
<td>(10)</td>
<td>(89)</td>
</tr>
<tr>
<td>Present value of future expenditures in excess of future revenue(^b)</td>
<td>($7)</td>
<td>($11)</td>
<td>($13)</td>
<td>($8)</td>
<td>($39)</td>
</tr>
</tbody>
</table>

Source: The Department of the Treasury

\(^a\)These amounts include administrative expenses for the programs.

\(^b\)Under current law, Social Security and Federal Hospital Insurance (Medicare Part A) payments are limited to amounts available to the respective trust funds.

Note: Data are from the fiscal year 2006 Financial Report.

**Major Reported Long-Term Fiscal Exposures**

GAO developed the concept of “fiscal exposures” to provide a framework for considering the wide range of responsibilities, programs, and activities that explicitly or implicitly expose the federal government to future spending.

The concept of fiscal exposures is meant to provide a broader perspective on long-term costs. Major reported long-term fiscal exposures in fiscal year 2006 with a present value totaling over $50 trillion consisted of about $10 trillion of liabilities reported on the Balance Sheet, $1 trillion of other commitments and contingencies, and the $39 trillion of social insurance responsibilities, the last two of which are reported elsewhere in the Financial Report. This $50 trillion compares to about $20 trillion in fiscal year 2000.

These large numbers are difficult to comprehend. Table 2 seeks to translate them into several figures and ratios that are more understandable.
Table 2: Understanding the Size of Major Reported Fiscal Exposures

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2006</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major fiscal exposures</td>
<td>$20.4 trillion</td>
<td>$50.5 trillion</td>
<td>147%</td>
</tr>
<tr>
<td>Total household net worth</td>
<td>$42.0 trillion</td>
<td>$53.3 trillion</td>
<td>27%</td>
</tr>
<tr>
<td>Ratio of fiscal exposures to net worth</td>
<td>49 percent</td>
<td>95 percent</td>
<td>94%</td>
</tr>
</tbody>
</table>

### Burden

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2006</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per person</td>
<td>$70,000</td>
<td>$170,000</td>
<td>132%</td>
</tr>
<tr>
<td>Per full-time worker</td>
<td>$165,000</td>
<td>$400,000</td>
<td>143%</td>
</tr>
<tr>
<td>Per household</td>
<td>$190,000</td>
<td>$440,000</td>
<td>134%</td>
</tr>
</tbody>
</table>

### Income

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2006</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median household income</td>
<td>$41,990</td>
<td>$46,326</td>
<td>10%</td>
</tr>
<tr>
<td>Disposable personal income per capita</td>
<td>$25,127</td>
<td>$31,519</td>
<td>25%</td>
</tr>
</tbody>
</table>

| Ratio of household burden to median income | 4.5 | 9.5 | 112% |

Sources: GAO analysis of data from the Department of the Treasury, Federal Reserve Board, U.S. Census Bureau, and Bureau of Economic Analysis.

Note: Percentage increases reflect actual data and may differ from calculation of rounded numbers presented in table.

### Long-Term Fiscal Simulations

Another way to assess the U.S. government’s long-term fiscal outlook and the sustainability of federal programs is to run simulations of future revenues and costs for all federal programs, based on a continuation of current or proposed policy. The simulations GAO has published since 1992 are designed to do that. As shown in figure 1, GAO’s long-term simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used; one alternative (baseline extended) takes the legislatively-mandated baseline from the Congressional Budget Office (CBO) for the first 10 years and then keeps discretionary spending and revenues constant as a share of GDP while letting Social Security, Medicare, and Medicaid grow as projected by the Trustees and CBO under midrange assumptions. The other, perhaps more realistic, scenario based on the administration’s announced policy preferences changes only two things in the first 10 years: discretionary spending grows with the economy and all expiring tax provisions are extended. Like the “baseline extended” scenario, after 10 years both revenues and discretionary spending remain constant as a share of the economy. Under either optimistic set of assumptions, the federal government’s current fiscal policy is unsustainable.
Over the long term, the nation’s growing fiscal imbalance stems primarily from the aging of the population and rising health care costs. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today’s and tomorrow’s commitments. Continuing on this unsustainable path will gradually erode, if not suddenly damage our economy, our standard of living, and ultimately our domestic tranquility and national security.

If, for example, as shown in figure 2, it is assumed that recent tax reductions are made permanent and discretionary spending keeps pace with the growth of our economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on debt held by the public and some Social Security benefits. Neither slowing the growth in discretionary spending nor allowing the tax provisions, including the tax cuts enacted in 2001 and 2003, to expire—nor both together—would eliminate the imbalance. As figures 1 and 2 illustrate,
regardless of the assumptions used, the problem is too big to be solved by economic growth alone.

Figure 2: Potential Fiscal Outcomes under Alternative Simulation: Discretionary Spending Grows with GDP after 2007 and All Expiring Tax Provisions Are Extended

Note: Alternative Minimum Tax (AMT) exemption amount is retained at the 2006 level through 2017 and expiring tax provisions are extended. After 2017, revenue as a share of GDP is held constant—implicitly assuming that action is taken to offset increased revenue from real bracket creep, the AMT, and tax-deferred retirement accounts.

At some point, action will need to be taken to change the nation’s fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation’s long-term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing. Acting sooner rather than later will give us more time to phase in gradual changes, while also providing more time for those likely to be most affected to make compensatory changes.

The “fiscal gap” is a quantitative measure of long-term fiscal imbalance. Under GAO’s more realistic simulation, assuming debt held by the public
remains at the current share of the economy (i.e., GDP), closing the fiscal gap would require spending cuts or tax increases equal to 8 percent of the entire economy each year over the next 75 years, or a total of about $61 trillion in present value terms. To put this in perspective, closing the gap would require an immediate and permanent increase in federal tax revenues of more than 40 percent or an equivalent reduction in federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled).

A Possible Way Forward

Although the long-term fiscal outlook is driven primarily by rising health care costs and known demographics, we cannot ignore other government programs and activities. There is a need to engage in a fundamental review, reprioritization, and reengineering of the base of government. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed. Many of the federal government’s current policies, programs, functions, and activities are based on conditions that existed decades ago, are not results-based, and are not well aligned with 21st century realities. We need to address the growing costs of the major entitlement programs and also review and reexamine all other major programs, policies, and activities on both the spending and the revenue side of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures—must be reexamined along with those that run through the spending side. As we move forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results. I recently provided all members of the new Congress with a package of materials to help them understand facts regarding the long-term fiscal

\[5\] In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.
imbalance of the federal government, why we should act sooner rather than later, and what types of changes need to be considered.⁶

Meeting our nation’s large, growing, and structural fiscal imbalance will require a multipronged approach:

- increasing transparency and enhancing the relevancy of key financial, performance, and budget reporting and estimates to highlight our long-term fiscal challenges;
- reinstituting and strengthening budget controls for both spending and tax policies to deal with both near-term and longer-term deficits;
- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and
- reengineering and reprioritizing the federal government’s existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

In two of my January 2007 testimonies,⁷ I proposed a number of ideas for consideration to improve the transparency of long-term costs, including supplemental reporting in the President’s budget submission and additional cost information on proposals before adoption. In November 2006, I provided the congressional leadership with recommendations, based on the work of GAO, for consideration for the agenda of the 110th Congress.⁸ These recommendations focused on three areas: (1) targets for near-term oversight, (2) policies and programs that are in need of fundamental reform and reengineering, and (3) governance issues. One of


the areas I pointed out that warranted congressional attention was the
development of a portfolio of outcome-based key national indicators (e.g.,
economic, security, social, environmental) to help measure progress
toward national outcomes, assess conditions and trends, and help communicate complex issues. The Congress could take a leadership role in highlighting the need for a U.S. national indicator system to inform strategic planning, enhance performance and accountability reporting, inform congressional oversight and decision making, and stimulate greater citizen engagement. In my view, this should include consideration of a public/private partnership to help make this key concept a reality sooner rather than later.

In order to effectively address our long-term fiscal imbalance, fundamental reform of existing entitlement programs is essential. However, entitlement reform alone will not get the job done. We also need to reprioritize and constrain other federal government spending and generate more revenues—hopefully through a reformed tax system. *GAO’s 21st Century Challenges: Reexamining the Base of the Federal Government* contains a suggested list of specific federal activities for reexamination, illustrative reexamination questions, and perspectives on various strategies, processes, and approaches for congressional consideration stemming from our audit and evaluation work that can be used in reexamining the federal base. Answers to these questions may draw on the work of GAO and others; however, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and our fiscal clock is ticking. As a result, the time to start is now, to help save our future.

The federal government restated certain of its fiscal year 2005 consolidated financial statements to correct errors. Restatements relating to property, plant, and equipment resulted from misstatements by the

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10According to Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior-period financial statements presented should only be restated for corrections of errors, when such errors caused the financial statements to be materially misstated. Errors in financial statements can result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.
Department of Defense, which had received a disclaimer on its originally issued as well as its restated fiscal year 2005 financial statements.\textsuperscript{11} Certain other restatements that were made to the consolidated financial statements related to errors that occurred during the preparation of the fiscal year 2005 Reconciliation of Net Operating Cost and Unified Budget Deficit.

Since fiscal year 2004, we have reported our concerns about restatements to federal agencies’ previously issued financial statements. During fiscal year 2005, we reviewed the causes and nature of the restatements made by nine CFO act agencies in fiscal year 2004 to their fiscal year 2003 financial statements. Between 2005 and 2006 we issued reports covering five of these nine CFO act agencies that included recommendations for improvements in internal controls and procedures to prevent or detect future similar errors.\textsuperscript{12} In October 2006, we issued a capping report to the Office of Management and Budget (OMB), which communicated our observations on the transparency and timeliness of the nine federal agencies and their auditor’s restatement disclosures.\textsuperscript{13} The primary contributing factor for the restatement disclosure issues that we identified was insufficient guidance available at the time to both the agencies’ management and their respective auditors for disclosure of the restatements and the timeliness of such disclosures. In August 2005, OMB revised Circular No. A-136, \textit{Financial Reporting Requirements}, which provides additional guidance to federal agencies’ management regarding disclosure of restatements to previously issued financial statements. Revisions made to OMB Circular No. A-136 address many of our concerns

\textsuperscript{11}In addition to the Department of Defense, at least three other Chief Financial Officers (CFO) act agencies restated certain of their fiscal year 2005 financial statements to correct misstatements.


regarding the agencies' disclosure of restatements. In addition, in August 2006, OMB issued Bulletin No. 06-03, Audit Requirements for Federal Financial Statements, which provides some information regarding reporting on restatements. However, we believe that OMB needs to timely provide additional, though complementary, restatement guidance. As such, our October 2006 report contained recommendations to OMB to further improve the restatement guidance available to agencies' management and the agencies' respective auditors. In addition, the January 2007 revision of generally accepted government auditing standards (GAGAS) includes a section on reporting on restatement of previously issued financial statements.\textsuperscript{14}

Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. Material internal control weaknesses discussed in our fiscal year 2006 audit report serve to increase the risk that additional errors may occur and not be identified on a timely basis by agency management or their auditors, resulting in further restatements.

As has been the case for the previous nine fiscal years, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the U.S. government’s consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government’s consolidated financial statements for the fiscal years ended September 30, 2006, and 2005.\textsuperscript{15}

Appendix I describes the material weaknesses that contributed to our disclaimer of opinion in more detail and highlights the primary effects of

\textsuperscript{14}GAGAS, promulgated by the Comptroller General of the United States, are to be followed by federal auditors and audit organizations and by other auditors auditing federal organizations, programs, or activities when required by law, contract, or policy. These standards pertain to auditors’ professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. GAGAS incorporate American Institute of Certified Public Accountants’ field work and reporting standards and the related Statements on Auditing Standards for financial audits unless the Comptroller General of the United States excludes them by formal announcement.

\textsuperscript{15}We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2005.
these material weaknesses on the consolidated financial statements and on the management of federal government operations. The material weaknesses that contributed to our disclaimer of opinion were the federal government’s inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government’s consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) balanced, and (3) in conformity with GAAP; and
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury’s records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies’ financial statements and underlying financial information and records.

Due to the material weaknesses and the additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found the following four other material weaknesses in internal control as of September 30, 2006. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the consolidated financial statements and on the management of federal government operations. These other material weaknesses were the federal government’s inability to
implement effective credit reform estimation and related financial reporting processes,
determine the full extent to which improper payments exist,
identify and resolve information security control weaknesses and manage information security risks on an ongoing basis, and
effectively manage its tax collection activities.

Individual federal agency financial statement audit reports identify additional reportable conditions\textsuperscript{16} in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These additional reportable conditions do not represent material weaknesses at the governmentwide level. Regarding agencies' internal controls, in December 2004, OMB revised its Circular No. A-123, Management's Responsibility for Internal Control, to provide guidance to federal managers on improving the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting, and reporting on management controls. Requiring federal managers, at the executive level, to focus on internal control demonstrates a renewed emphasis on identifying and addressing internal control weaknesses.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multiyear implementation plans. OMB stated that it will continue to work with the Chief Financial Officers Council to identify potential areas for additional guidance and share agencies' best practices. It will be important that OMB monitor and oversee federal agencies' implementation of these new requirements.

For fiscal year 2006, 18 of 24 CFO Act agencies were able to attain unqualified opinions on their financial statements by the November 15, 2006, reporting deadline established by OMB (see app. III). The independent auditor of the Department of State subsequently withdrew its disclaimer of opinion on the department's fiscal year 2006 financial statements and reissued an unqualified opinion on such financial statements dated December 12, 2006. As a result, 19 CFO Act agencies

\textsuperscript{16}Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the federal government's ability to meet the internal control objectives described in our audit report.
received unqualified opinions on their fiscal year 2006 financial
statements. However, irrespective of these unqualified opinions, many
agencies do not have timely, reliable, and useful financial information and
effective controls with which to make informed decisions and ensure
accountability on an ongoing basis. The ability to produce the data needed
for efficient and effective management of day-to-day operations in the
federal government and provide the necessary accountability to taxpayers
and the Congress has been a long-standing challenge at most federal
agencies.

The results of the fiscal year 2006 assessments performed by agency
inspectors general or their contract auditors under the Federal Financial
Management Improvement Act of 1996 (FFMIA) show that serious
problems continue to affect financial management systems at most of the
24 CFO Act agencies. These problems include nonintegrated financial
systems, lack of accurate and timely recording of data, inadequate
reconciliation procedures, noncompliance with accounting standards and
the U.S. Government Standard General Ledger (SGL), and weak security
over information systems. While the problems are much more severe at
some agencies than at others, the nature and severity of the problems
indicate that overall, management at most CFO Act agencies lacks the
complete range of information needed for accountability, decision making,
and performance reporting.

Under FFMIA, as a part of the CFO Act agencies’ financial statement
audits, CFO Act agency auditors are required to report whether agencies’
financial management systems substantially comply with (1) federal
financial management systems requirements, (2) applicable federal
accounting standards, and (3) the SGL at the transaction level. These
factors are critical for improving accountability over government
operations and routinely producing sound cost and operating performance
information. Noncompliance with federal financial management systems
requirements was the deficiency most frequently reported by auditors.
These deficiencies involved not only core financial systems, but also
administrative and programmatic systems.

The ability of federal financial management systems to substantially
address FFMIA requirements has not advanced at the same pace as
obtaining unqualified opinions on agency financial statements. As shown
in figure 3, in fiscal year 2006, auditors for 17 of the 24 CFO Act agencies
reported that the agencies’ financial management systems did not
substantially comply with one or more of FFMIA’s three requirements
compared to auditors for 20 of the 24 CFO Act agencies in fiscal year 1997.
For 6 of the 7 CFO Act agencies whose auditors did not report substantial noncompliance with FFMIA requirements for fiscal year 2006, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies’ financial management systems did not substantially fulfill FFMIA requirements. The auditors for these 6 agencies\(^\text{17}\) did not definitively state whether the agencies’ systems substantially complied with FFMIA requirements, as is required under the statute. In contrast, auditors for the Agency for International Development (AID) provided positive assurance by stating that the agency’s financial management systems substantially complied with the requirements of FFMIA. AID’s auditors had not reported AID’s financial management systems as substantially compliant in prior years. Further, auditors for GSA cited actions taken to address financial reporting controls and provided negative assurance on FFMIA in fiscal year 2006; whereas, in

\(^{17}\)The CFO Act agencies whose auditors provided negative assurance were the Department of Commerce, Environmental Protection Agency, General Services Administration (GSA), National Science Foundation, Office of Personnel Management, and the Social Security Administration.
fiscal year 2005 they had reported the agency's systems as not compliant. Conversely, auditors for the Department of Labor (Labor) reported that the agencies' financial management systems did not substantially comply with FFMIA requirements in fiscal year 2006 due to newly identified weaknesses in Labor's information security controls. The auditors had not reported any FFMIA compliance issues at the agency in fiscal years 2004 and 2005.

In an effort to address FFMIA-related problems such as nonintegrated systems, inadequate reconciliations, and lack of compliance with the SGL, a number of agencies have efforts underway to implement new financial management systems or to upgrade existing systems. Agencies expect that the new systems will provide reliable, useful, and timely data to support managerial decision making, help provide accountability to taxpayers, and assist in congressional oversight. Whether in government or the private sector, implementing and upgrading systems is a resource-consuming and difficult job that brings a degree of risk. Organizations that follow and effectively implement accepted best practices in systems development and implementation (commonly referred to as disciplined processes) can manage and reduce these risks to acceptable levels. The failure to do so can have serious repercussions. For example, auditors at the Department of Energy (Energy) and the National Aeronautical and Space Administration (NASA) have reported many issues related to the implementation of new financial management systems at those agencies. NASA has received disclaimers of opinion on their financial statements since implementing their new system in fiscal year 2003. While management at both agencies are taking actions to address the problems resulting from the systems implementation, more work is needed to meet FFMIA requirements and obtain an unqualified opinion on their financial statements.

The financial management line of business is OMB's initiative to help address the need to reduce the cost and improve the outcome of federal financial systems implementations. This initiative promotes leveraging of shared service solutions to enhance the government's performance and services. OMB has projects under way to develop standard business processes, a common governmentwide accounting structure, and specific measures to assess the performance of shared service providers to help provide a foundation for the financial management line of business initiative. Because the federal government is one of the largest, most complex organizations in the world, operating, maintaining, and modernizing its financial management systems represents a monumental challenge—from both cost and technical perspectives. As pressure mounts
to increase accountability, and efforts to diminish federal spending intensify, sustained and committed leadership will be a key factor in the successful implementation of governmentwide initiatives.

### Addressing Major Impediments to an Opinion on the Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's consolidated financial statements continued to be: (1) serious financial management problems at DOD, (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. Extensive efforts by DOD officials and cooperative efforts between agency chief financial officers, inspectors general, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's consolidated financial statements.

### Financial Management at DOD

Essential to further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government’s consolidated financial statements is the resolution of serious weaknesses in DOD’s business operations. DOD is one of the largest and most complex organizations in the world. For decades, we have reported on the lack of efficiency and effectiveness in DOD’s business operations, including financial management, and the effect these deficiencies have had on the department’s, and the government’s, ability to oversee, manage, and report on its operations. DOD’s financial management weaknesses are pervasive, complex, long-standing, and deeply rooted in virtually all its business operations. Execution of DOD’s business operations spans a wide range of defense organizations, including the military services and their respective major commands and functional activities, numerous large defense agencies and field activities, and various combatant and joint operational commands that are responsible for military operations for specific geographic regions or theaters of operations. The nature and severity of DOD’s business operations and system deficiencies not only affect financial reporting, but also impede the ability of DOD managers to receive and utilize the full range of information needed to effectively manage day-to-day operations. Such weaknesses adversely affect DOD’s (and the government’s) ability to control costs; ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent fraud, waste, and abuse; and address
pressing management issues, including supporting warfighters and their families. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in business management processes, controls, and systems. Moreover, of the 27 areas on GAO’s high-risk list, DOD has 8 of its own high-risk areas and shares responsibility for 7 governmentwide high-risk areas.

Effective oversight, reporting, and decision making depends upon information that is timely, reliable, and useful. DOD has transformation efforts underway to improve its business management processes, control, and systems. These efforts will take many years to complete and represent a huge challenge to the department since improvements must be made while continuing to support ongoing operations and activities. While the department is making progress in developing and implementing approaches to better understand and address weaknesses in its business operations, more remains to be done.

On March 1, 2006, I testified that DOD had issued a third key component of its business transformation strategy: the Financial Improvement and Audit Readiness (FIAR) Plan. According to DOD, the FIAR Plan, which was issued in December 2005 and updated in June and September of 2006, is intended to provide DOD components with a construct for resolving problems affecting the accuracy, reliability, and timeliness of financial statements.

18Although not major DOD components, the Military Retirement Fund received an unqualified audit opinion on its fiscal year 2006 financial statements, and the DOD Medicare Eligible Retiree Health Care Fund received a qualified audit opinion on its fiscal year 2006 financial statements.

19GAO, High-Risk Series: An Update, GAO-07-310 (Washington, D.C.: January 2007). The eight specific DOD high-risk areas are: (1) approach to business transformation, (2) business systems modernization, (3) contract management, (4) financial management, (5) personnel security clearance program, (6) supply chain management, (7) support infrastructure management, and (8) weapon systems acquisition. The seven governmentwide high-risk areas are (1) disability programs, (2) interagency contracting, (3) information systems and critical infrastructure, (4) information sharing for homeland security, (5) human capital, (6) real property, and (7) protection of critical technologies.


21The Business Enterprise Architecture and the Enterprise Transition Plan are the other two key components of DOD’s business transformation strategy.
information, and obtaining clean financial statement audit opinions. In addition, the FIAR Plan outlines the business rules and oversight structure DOD has established to guide financial improvement activities and audit preparation efforts. According to DOD, its June and September 2006 FIAR Plan updates were largely intended to refine previous versions of the plan by (1) identifying milestones that must be met for assertions regarding the reliability of reported financial statement information to occur on time, (2) improving consistency between components regarding their corrective actions and milestones, and (3) expanding on earlier descriptions of how the FIAR Plan will be integrated with the Enterprise Transition Plan. We have reported and made numerous recommendations to DOD regarding DOD’s efforts to develop and implement its Business Enterprise Architecture and Transition Plan and obtain favorable audit opinions. In addition, we have reviewed the FIAR Plan and related updates, and discussed them with DOD and OMB. However, we cannot comment on specific focus areas or milestones identified in the FIAR Plan because we have not seen any of the underlying component or other subordinate plans upon which the FIAR Plan is based.

DOD has taken important steps toward developing key components of its business transformation strategy. However, we continue to stress that while the reliability of reported financial statement information is important, the effectiveness of DOD’s FIAR Plan in addressing the department’s financial management deficiencies will ultimately be measured by the department’s ability to provide timely, reliable, and useful information for day-to-day management and decision making. Furthermore, the department continues to lack a comprehensive, enterprisewide approach to planning and decision making and the sustained leadership needed to ensure successful transformation and address systemic business challenges. More specifically, DOD has not yet developed a plan that covers all key business functions, and contains results-oriented goals, measures, and expectations that link organizational and individual performance goals, while also being clearly linked to DOD’s overall investment plans. Furthermore, as we previously testified, because of the complexity and long-term nature of business transformation, we continue to believe that DOD needs a Chief Management Official (CMO) with significant authority, experience, and tenure to provide sustained leadership and integrate DOD’s overall business transformation efforts.

The National Defense Authorization Act for Fiscal Year 2006\(^2\) directs the

department to study the feasibility of a CMO position in DOD. In this regard, the Institute for Defense Analysis issued its report in December 2006 and, among other things, called upon the Congress to establish a Deputy CMO (executive level III official) at the department. Further, in May 2006, the Defense Business Board recommended, among other things, the creation of a Principal Under Secretary of Defense, as a level II official with a 5-year term appointment, to serve as CMO. I strongly support an executive level II official and believe that someone at this level is needed to be successful given the magnitude of the challenge and the need to effect change across the department. It is important to note that a CMO would not assume the responsibilities of the undersecretaries of defense, the service secretaries, or other DOD officials for the day-to-day management of the department. Rather, the CMO would be responsible and accountable for planning, integrating, and executing the overall business transformation effort. The reason I am so passionate about the need for a CMO at DOD is that progress at DOD has historically been painfully slow. A host of well-intended past improvement initiatives have largely failed. I am concerned that without a CMO who is responsible and accountable for demonstrable results and sustained success, history will continue to repeat itself.

We will continue to monitor DOD’s efforts to transform its business operations and address its financial management deficiencies as part of our continuing DOD business enterprise architecture work and our oversight of DOD’s financial statement audit.

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the CFOs of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency’s inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the CFO Act agencies did not adequately perform the required reconciliations for fiscal years 2006 and 2005. For these fiscal years, based on trading partner information provided in the

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Intragovernmental Activity and Balances

Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.
Governmentwide Financial Reporting System (GFRS) discussed below, Treasury produced a “Material Difference Report” for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. After analysis of the “Material Difference Reports” for fiscal year 2006, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses on the CFO Representations. For both fiscal years 2006 and 2005, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, for fiscal year 2006, about 31 percent of the significant agencies identified by Treasury and OMB did not perform the required audit procedures on their intragovernmental trading partner data included in the footnotes to their closing packages. As a result of the above, the federal government’s ability to determine the effect of these differences on the amounts reported in the consolidated financial statements is significantly impaired.

To help address this longstanding problem, on November 13, 2006, OMB issued Memorandum No. M-07-03, Business Rules for Intragovernmental Transactions, which has also been incorporated in the Treasury Financial Manual. The OMB memorandum added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions by creating the Chief Financial Officers Council’s Intragovernmental Dispute Resolution Committee. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules, and continued strong leadership by OMB.

While further progress was demonstrated in fiscal year 2006, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are

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24GFRS uses a closing package methodology that has been developed to capture each federal agency’s information and link the agencies’ audited financial statements to the governmentwide consolidated financial statements.


26The U.S. Chief Financial Officer’s Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of OMB and Treasury who work collaboratively to improve financial management in the U.S. government.
consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. For fiscal year 2006, Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies’ audited financial statements and that the Balance Sheet and Statement of Net Cost were consistent with federal agencies’ audited financial statements prior to eliminating intragovernmental activity and balances. However, Treasury’s process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies’ audited financial statements and other financial data. During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

The Financial Report of the United States Government provides useful information on the government’s financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation’s fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal imbalance of the government—that is, the sustainability of the federal government’s programs, commitments, and responsibilities in relation to the resources expected to be available. More important than the government’s $450 billion net operating cost for the year ended September 30, 2006, fiscal simulations by GAO and others show that over the long-term, we face large and growing structural deficits due primarily to Medicare and other social insurance commitments.

As I have testified before, the current financial reporting model does not clearly, comprehensively, and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it provides a potentially unrealistic and misleading picture of the federal government’s overall performance, financial condition, and future fiscal outlook.
After a decade of reporting at the governmentwide level perhaps now is an appropriate time to step back and consider the need for further revisions to the current federal financial reporting model, which would affect both consolidated and agency financial reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions:

- What kind of information is most relevant and useful for a sovereign nation?
- Do traditional financial statements convey information in a transparent manner?
- What is the role of the balance sheet in the federal government reporting model?
- How should items that are unique to the federal government, such as social insurance commitments and the power to tax, be reported?

Engaging in a reevaluation of this nature could stimulate discussion that would bring about a new way of thinking about the federal government’s financial and performance reporting needs. To understand various perceptions and needs of the stakeholders for federal financial reporting, a wide variety of stakeholders from the public and private sector should be consulted. Ultimately, the goal of such a reevaluation would be reporting enhancements that can help the Congress deliberate strategies to address the federal government’s challenges, including those of our growing long-term fiscal imbalance.

More specifically, we continue to support several specific improvements to federal financial reporting. For example, the federal government’s financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include a Statement of Fiscal Sustainability—providing a long-term look at the sustainability of current federal fiscal policy in the context of all major federal spending programs and tax policies. The reporting on fiscal sustainability should include additional information that will assist in understanding the sustainability of current social insurance and other federal programs, including key measures of fiscal sustainability and intergenerational equity.\(^2\) Projected annual cash

\(^2\)Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.
flows, and changes in fiscal sustainability during the reporting period. We believe that such reporting needs to reflect the significant commitments associated with the Social Security and Medicare programs while recognizing a liability for the net assets (principally investments in special U.S. Treasury securities) of the “trust funds.” Other areas to consider might include the reporting of key outcome-based performance information. We support the current efforts of the Federal Accounting Standards Advisory Board (FASAB) to begin a project on fiscal sustainability reporting. In addition, an easily understandable summary annual report should be prepared and published that includes in a clear, concise, and transparent manner, key financial and performance information embodied in the Financial Report.

In closing, given the federal government’s current financial condition and growing long-term fiscal imbalance, the need for the Congress and the President to have timely, reliable, and useful financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Addressing the nation’s long-term fiscal imbalance constitutes a major transformational challenge that may take a generation or more to resolve. Given the size of the projected deficit, the U.S. government will not be able to grow its way out of this problem—tough choices will be required.

Across government, financial management improvement initiatives are underway, and if effectively implemented, have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. By the end of my term as Comptroller General, I would like to see the civilian CFO Act agencies routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis. For DOD, my expectations are not as high given the current status of DOD’s financial management practices, yet it is realistic for at least major portions of DOD’s financial information to become auditable by the end of my term. Moreover, progress on developing meaningful financial and performance reporting on the federal government will be a key area that I will continue to champion. I am determined to do whatever I can to help ensure that we are not the first
generation to leave our children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this subcommittee’s leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director; Gary T. Engel, Director; and Paula Rascona, Acting Director; Financial Management and Assurance, at (202) 512-2600. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.
Appendix I: Material Weaknesses Contributing to Our Disclaimer of Opinion

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the consolidated financial statements, as described below.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs, or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government’s interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government’s current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation
affect the federal government’s ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government’s obligations.

The previously discussed material weaknesses in reporting assets and liabilities, material weaknesses in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2006 and 2005, there was unreconciled disbursement activity, including unreconciled differences between federal agencies’ and the Department of the Treasury’s (Treasury) records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government’s ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in The Budget of the United States Government concerning obligations and outlays.

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency’s inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2006 and 2005. For these fiscal
years, based on trading partner information provided in the Governmentwide Financial Report System (GFRS), Treasury produced a “Material Difference Report” for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. After analysis of the Material Difference Reports for fiscal year 2006, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses on the CFO Representations. For both fiscal years 2006 and 2005, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, for fiscal year 2006, about 31 percent of the significant agencies identified by Treasury and OMB did not perform the required audit procedures on their intragovernmental trading partner data included in the footnotes to their closing packages. As a result of the above, the federal government’s ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is significantly impaired.

While further progress was demonstrated in fiscal year 2006, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). In addition, as discussed in our scope limitation section of our audit report, Treasury could not provide the final fiscal year 2006 consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2006 audit, we found the following:

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1 GFRS uses a closing package methodology that has been developed to capture each federal agency’s information and link the agencies’ audited financial statements to the governmentwide consolidated financial statements.

2 Most of the issues we identified in fiscal year 2006 existed in fiscal year 2005, and many have existed for a number of years. In April 2006, we reported in greater detail on the issues we identified, in GAO, Financial Audit: Significant Internal Control Weaknesses Remain in Preparing the Consolidated Financial Statements of the U.S. Government, GAO-06-415 (Washington, D.C.: Apr. 21, 2006). This report includes numerous recommendations to Treasury and OMB.
Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies’ audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies’ financial statements prior to eliminating intragovernmental activity and balances. However, Treasury’s process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies’ audited financial statements and other financial data.

To make the fiscal years 2006 and 2005 consolidated financial statements balance, Treasury recorded net decreases of $11 billion and $4.1 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled “Other—Unmatched transactions and balances.” An additional net $10.4 billion and $3.2 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2006 and 2005, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

The federal government did not have an adequate process to fully identify and report items needed to reconcile the operating results, which for fiscal year 2006 showed a net operating cost of $449.5 billion, to the budget results, which for the same period showed a unified budget deficit of $247.7 billion.

Treasury’s elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies’ problems in handling their intragovernmental transactions. As discussed above, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. This resulted in the need for unsupported intragovernmental elimination entries by Treasury in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the consolidated financial statements.

We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new

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3 Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to operations, it reported this amount as a component of net operating cost in the consolidated financial statements.
standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that Treasury had not been reporting. Treasury has plans to address certain of the omitted disclosures in future years’ consolidated financial statements. Because of certain of the material weaknesses noted in our audit report, we were unable to determine if the omitted information was material to the consolidated financial statements.

- Treasury continued to make progress in addressing certain other internal control weaknesses in Treasury’s process for preparing the consolidated financial statements. However, internal control weaknesses continued to exist involving a lack of (1) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (2) adequate supporting documentation for certain adjustments made to the consolidated financial statements, and (3) effective management reviews.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, as we have reported in past years, there continue to be undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.

- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2006 financial reporting challenges it faced, such as (1) GFRS undergoing further development and not yet being fully operational, and (2) weaknesses in Treasury’s process for preparing the consolidated financial statements as discussed above. We found that personnel at Treasury’s Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date.

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During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report the budget deficit for fiscal years 2006 and 2005 of $247.7 billion and $318.6 billion, respectively. The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies’ Statement of Budgetary Resources (SBR) and Treasury’s central accounting records used to compute the budget deficit reported in the consolidated financial statements. OMB and Treasury have been working with federal agencies to reduce these material unreconciled differences. Such efforts have resulted in significantly reducing the net outlay differences in fiscal year 2006. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury’s central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government’s consolidated financial statements will be unknown.

The budget deficit, receipts, and outlays amounts are reported in Treasury’s Monthly Treasury Statement and the Budget of the United States Government.

In fiscal year 2006, we again noted that several agencies’ auditors reported internal control weaknesses (1) affecting the agencies’ SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies’ SBRs. In addition, such weaknesses also affect the agencies’ ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its Combined Statement of Receipts, Outlays, and Balances, and certain amounts reported in the President’s Budget.

*Treasury’s Combined Statement of Receipts, Outlays, and Balances presents budget results and cash-related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.*
Appendix II: Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2006. In addition to the material weaknesses discussed in appendix I that contributed to our disclaimer of opinion, we found the following four other material weaknesses in internal control.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies accounting for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by federal credit agencies, these issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Further, these weaknesses continue to adversely affect the federal government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.

Improper Payments

Under the leadership of OMB, agencies have continued to make progress in addressing improper payments. Improvements, though, are still needed to fully address the requirements of the Improper Payments Information Act of 2002 (IPIA).¹ Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.² The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments,³ estimate and report the annual amount of improper payments for those programs, and


³IPIA defines improper payments as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts. OMB's guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and $10 million annually.
implement actions to cost-effectively reduce improper payments. In addition, OMB has established a program-specific initiative under the President’s Management Agenda for 15 federal agencies to hold federal agency managers accountable for meeting the goals of IPIA and to ensure that the necessary attention and resources are dedicated to meeting the IPIA requirements.

For fiscal year 2006, federal agencies’ estimates of improper payments, based on available information, totaled about $42 billion, a net increase of about $4 billion, or an 11 percent increase, from the prior year improper payment estimate of $38 billion. This increase was primarily attributable to 10 newly reported programs with improper payment estimates totaling about $2.3 billion and certain federal agencies reporting an increase in estimates for programs that had previously reported.

We found that some agencies have not annually reviewed all programs and activities, have not estimated improper payments for all risk-susceptible programs, or have not estimated improper payments for all components of risk-susceptible programs. For example, we noted that in fiscal year 2006, improper payment estimates were not made for 9 risk-susceptible federal programs, including Medicaid, with total program outlays of about $183 billion for fiscal year 2006. Further, we noted some agencies reported noncompliance issues and major management challenges related to IPIA implementation, including the methodologies used to estimate improper payments, adequacy of agency documentation, management oversight, and contract management.

Although progress has been made, serious and widespread information security control weaknesses continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A

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4In their fiscal year 2006 Performance and Accountability Reports (PAR), selected federal agencies updated their fiscal year 2005 improper payment estimates to reflect changes since issuance of their fiscal year 2005 PARs. These updates increased the governmentwide improper payment estimate for fiscal year 2005 from $38 billion to $39 billion.
primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced by hearings on the implementation of the Federal Information Security Management Act of 2002 and on information security. In addition, the administration has taken important actions to improve information security, such as requiring agencies in OMB Memorandum M-06-16 to perform specific actions to protect certain personally identifiable information and issuing extensive guidance on information security.

**Material internal control weaknesses and systems deficiencies continue to affect the federal government’s ability to effectively manage its tax collection activities, an issue that has been reported in our financial statement audit reports for the past 9 years. Due to errors and delays in recording taxpayer information, payments, and other activities, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.**

Weaknesses in controls over tax collection activities continue to affect the federal government’s ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting of revenues affect the federal government’s ability to make informed decisions about collection efforts. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

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6OMB Memorandum No. M-06-16, Protection of Sensitive Agency Information (June 23, 2006).

## Table 3: CFO Act Agencies: Fiscal Year 2006 Audit Results and Principal Auditors

<table>
<thead>
<tr>
<th>CFO Act agencies</th>
<th>Opinion rendered by agency auditor</th>
<th>Agencies' auditors reported material weaknesses or noncompliance</th>
<th>Principal auditor</th>
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<tbody>
<tr>
<td>Agency for International Development</td>
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<td>OIG</td>
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<td>Deloitte &amp; Touche LLP</td>
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</table>

Source: GAO.

*For fiscal year 2006, only the Consolidated Balance Sheet of the Department of Energy was subjected to audit, and the auditor qualified its opinion on this statement.

*For fiscal year 2006, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subjected to audit; the auditor was unable to express an opinion on these two financial statements.

The auditor of the Department of State’s (State) fiscal year 2006 financial statements disclaimed an opinion because they were not provided complete financial statements or responses to certain requests for evidential material in time to meet the November 15, 2006, reporting deadline. Subsequently, the auditors satisfied themselves about the amounts presented on the financial statements. As a result, the auditor issued an unqualified opinion on State’s fiscal year 2006 financial statements dated December 12, 2006.
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