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

Given the federal government's fiscal challenges, there is a significant need for transparency and for the Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information. Even though significant progress has been made since the enactment of key financial management reforms in the 1990s, our report on the U.S. government's consolidated financial statements illustrates that much work remains to improve federal financial management. Consequently, financial management needs to be a top priority of this administration and the new Congress.

The recent economic recession and the federal government's actions to stabilize financial markets and promote economic recovery continued to significantly affect the federal government's financial condition. The U.S. government's consolidated financial statements for fiscal year 2010 include, as they did for fiscal year 2009, substantial assets and liabilities resulting from such actions. Although the federal government has received positive returns from investments in certain large financial institutions, it continues to report significant costs related to these actions. The ultimate cost of all of the federal government's market stabilization and economic recovery actions and the effect of such actions on its financial condition will not be known for some time.

The federal government faces long-term challenges resulting from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. These challenges are clearly shown in the comprehensive long-term fiscal projections presented in this *2010 Financial Report of the United States Government* (*2010 Financial Report*). While the economy is still fragile and in need of careful attention, there is wide agreement on the need to look not only at the near term but also at steps that begin to change the long-term fiscal path as soon as possible without slowing the economy.

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 years 2010 and 2009 accrual-based financial statements.[1] About 32 percent of the federal government's reported total assets as of September 30, 2010, and approximately 25 percent of the federal government's reported net cost for fiscal year 2010 relate to three agencies' fiscal year 2010 financial statements that, as of the date of our report, either received disclaimers of opinion or were not audited.[2]

- Because of significant uncertainties, as discussed in our report, we are unable to, and we do not, express an opinion on the 2010 Statement of Social Insurance. About $22.8 trillion, or 74 percent, of the federal government's reported total present value of future expenditures in excess of future revenue for 2010 relate to the Department of Health and Human Services' 2010 Statement of Social Insurance, which received a disclaimer of opinion. In our opinion, the Statements of Social Insurance for 2009, 2008, and 2007 present fairly, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with U.S. generally accepted accounting principles.[3]

- 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 2010 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 14 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:

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[1]The accrual-based consolidated financial statements for the fiscal years ended September 30, 2010 and 2009, 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 2010, 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.

[2]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 2010 financial statements were the Department of Defense and the Department of Labor. For the Department of Homeland Security for fiscal year 2010, 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.

[3]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.

(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 to the material weaknesses underlying these major impediments, we noted three other material weaknesses. Until the problems outlined in our 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.

Additional details regarding the material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations can be found in our report.

The federal government reported a net operating cost of about $2.1 trillion and a unified budget deficit of approximately $1.3 trillion for fiscal year 2010, and as of September 30, 2010, debt held by the public increased to about 62 percent of gross domestic product (GDP).

In December 2007, the United States entered what has turned out to be its deepest recession since the end of World War II. GDP fell 4.1 percent from the beginning of the recession through the second quarter of 2009, which marked the recession's end. Since the end of the recession, GDP has grown slowly and unemployment remains at a high level.

As of September 30, 2010, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in assets of over $400 billion, which is net of about $75 billion in valuation losses. In addition, the federal government reported incurring significant liabilities 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 reported by the federal government that are subject to substantial uncertainty include the following:

- The federal government's consolidated financial statements for fiscal year 2010 include approximately $109 billion of investments in Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) (net of about $46 billion in valuation losses), about $360 billion of liabilities for future payments to these entities, and about $276 billion of related net cost. The notes to the fiscal year 2010 financial statements also discuss an estimated additional $102 billion of future payments that could be incurred under an "extreme case" scenario, based on the estimates as of September 30, 2010.

- The federal government reported Troubled Asset Relief Program direct loans and equity investments of approximately $142 billion as of September 30, 2010 (net of about $37 billion in valuation losses, including about $21 billion related to American International Group, Inc., (AIG) and about $15 billion related to loans to and equity investments in certain entities in the automotive industry, including General Motors Company).

- The federal government reported Federal Deposit Insurance Corporation (FDIC) liabilities of about $73 billion as of September 30, 2010, related to estimated failures of insured financial institutions, guarantees, and bank resolutions. The FDIC's Deposit Insurance Fund (DIF) reported a negative reserve to estimated insured deposits. Although 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 deteriorate.

- Further deterioration in the residential real-estate market could result in additional losses for the Federal Housing Administration beyond the reported loan guarantee liability of about $35 billion as of September 30, 2010.

- The federal government reported that the Pension Benefit Guaranty Corporation's (PBGC) liabilities exceeded its assets by $23 billion as of September 30, 2010. PBGC is subject to further losses if plan terminations that are reasonably possible occur.

The ultimate cost of the federal government's actions to stabilize the financial markets and promote economic recovery will not be known for some time as these uncertainties are resolved and further federal government actions are taken in fiscal year 2011 and later. Looking ahead, the federal government will need to continue to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. Further, there are risks that the federal government's financial condition could be affected in the future by other factors, including the following:

- Although the American Recovery and Reinvestment Act of 2009[4] 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.

- Several initiatives undertaken during the past 2 years 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 net purchase of over $1.25 trillion in mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and Government National Mortgage Association (Ginnie Mae) as of September 2010. These purchases were funded primarily through an increase in deposits at the Federal Reserve by depository institutions. The Federal Reserve announced plans to replace about $300 billion of the mortgage-backed securities with longer-term Department of the Treasury (Treasury) securities and purchase $600 billion in additional longer-term Treasury securities. The valuation of these securities is subject to interest rate risk and may decline or increase in value in an environment of increasing or decreasing interest rates, respectively. 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.[5]

- Problems in the nation's financial sector exposed serious weaknesses in the 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 Dodd-Frank Wall Street Reform and Consumer Protection Act[6] (Dodd-Frank Act), among other things, creates a new financial stability oversight council, creates a new consumer financial protection bureau, requires more derivatives to be cleared and traded through regulated exchanges, and provides federal regulators with enhanced power to supervise and liquidate large failing firms. Importantly, the future structures of Fannie Mae and Freddie Mac and the roles they will serve in the mortgage markets must still be determined, as the Dodd-Frank Act does not address these two key government-sponsored enterprises.

The federal government faces even larger fiscal challenges in the long term. As discussed in the *2010 Financial Report*, the federal government is on an unsustainable long-term fiscal path driven on the spending side primarily by rising health care costs and known demographic trends. Under new financial reporting standards, this *2010 Financial Report* includes comprehensive long-term fiscal projections for the U.S. government, expanding on similar information presented in recent years' financial reports. These projections show continual increases in debt as a percentage of GDP, meaning fiscal policy is unsustainable over the long term. Also, the projections show that the present value of

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[4]Pub. L. No. 111-5, 123 Stat. 115 (Feb. 17, 2009).
[5]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 reported such net earnings of about $76 billion for fiscal year 2010.
[6]Pub. L. No. 111-203 (July 21, 2010).

projected non-interest spending exceeds receipts by about $16.3 trillion over the next 75-year period. The projections relating to Social Security and Medicare are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume reductions in Medicare cost growth. GAO also prepares long-term fiscal projections for the U.S. government.[7] Under GAO's Alternative simulation, absent policy change, debt held by the public as a share of GDP would exceed the historical high reached in the aftermath of World War II by 2020.[8]

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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 report begins on page 221. Our guide[9] 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* and is available on GAO's Web site at www.gao.gov. In addition, the Web site includes a guide[10] to understanding the differences between accrual and cash measures of the deficit and provides a useful perspective on the different purposes cash

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[7]GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2010 Update*, GAO-11-201SP (Washington, D.C.: November 2010).
[8]GAO's Alternative simulation incorporates Congressional Budget Office and Centers for Medicare & Medicaid Services alternative projections for health care cost growth, which assume certain cost controls are not maintained over the long term and physician payments are not reduced as specified under current law. Also in this simulation, all tax provisions are extended to 2020 and the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2020; revenues are then brought back to the 40-year historical average as a share of GDP; and discretionary spending grows with GDP during the entire period—keeping it just below the 40-year historical average as a share of GDP.
[9]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).
[10]See http://www.gao.gov/special.pubs/longterm/deficit/, which is based on information in 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).

and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.

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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