



United States Government Accountability Office
Washington, DC 20548

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

The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, is required to annually submit financial statements for the U.S. government to the President and the Congress. GAO is required to audit these statements.¹ This is (1) our report on the accompanying U.S. government's accrual-based consolidated financial statements for the fiscal years ended September 30, 2011 and 2010; the 2011, 2010, 2009, 2008, and 2007 Statements of Social Insurance; and the 2011 Statement of Changes in Social Insurance Amounts; and (2) our associated reports on internal control over financial reporting and on compliance with selected provisions of laws and regulations. As used in this report, accrual-based financial statements refer to all of the consolidated financial statements and notes, except for those related to the Statements of Social Insurance and the Statement of Changes in Social Insurance Amounts.²

Management of the federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP); (2) establishing, maintaining, and evaluating internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act (FMFIA)³ are met; and (3) complying with laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies are responsible for implementing and maintaining financial management systems that substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).⁴ Appendix I discusses the objective, scope, and methodology of our work.

¹The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331(e). The federal government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.

²The accrual-based consolidated financial statements for the fiscal years ended September 30, 2011 and 2010 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 2011, 2010, 2009, 2008, and 2007 Statements of Social Insurance, including the related notes, are also included in the consolidated financial statements. In addition, in fiscal year 2011, the federal government adopted Statement of Federal Financial Accounting Standards No. 37, "Social Insurance: Additional Requirements for Management's Discussion and Analysis and Basic Financial Statements," which calls for a new basic financial statement, the Statement of Changes in Social Insurance Amounts, that is included, along with the related notes, in the consolidated financial statements. The Statement of Changes in Social Insurance Amounts presents the components of the changes of the open group measure (total present value of future expenditures in excess of future revenue), presented in the 2011 and 2010 Statements of Social Insurance. Both the Statements of Social Insurance and the Statement of Changes in Social Insurance Amounts do not interrelate with the accrual-based consolidated financial statements.

³31 U.S.C. 3512 (c), (d) (commonly referred to as FMFIA). This act requires executive agency heads to evaluate and report annually to the President and the Congress on the adequacy of their internal control and accounting systems and on actions to correct significant problems.

⁴31 U.S.C. 3512 note (Federal Financial Management Improvement Act).

In summary, we found the following:

- Certain material weaknesses⁵ in internal control over financial reporting and other limitations on the scope of our work⁶ resulted in conditions that continued to prevent us from expressing an opinion on the accompanying accrual-based consolidated financial statements for the fiscal years ended September 30, 2011 and 2010.⁷
- Significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2011 and 2010 Statements of Social Insurance, prevented us from expressing an opinion on those statements as well as on the 2011 Statement of Changes in Social Insurance Amounts. The Statements of Social Insurance for 2009, 2008, and 2007⁸ are presented fairly, in all material respects, in conformity with GAAP.
- 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 2011 was limited by the material weaknesses and other scope limitations discussed in this report.

Significant Matters of Emphasis

Before discussing our conclusions on the consolidated financial statements, the following key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *2011 Financial Report of the United States Government (2011 Financial Report)* into context.

⁵A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

⁶Three major impediments continued to prevent us from rendering an opinion on the accrual-based consolidated financial statements: (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 entities, and (3) the federal government's ineffective process for preparing the consolidated financial statements. In addition, the Department of Homeland Security (DHS) received a qualified opinion on its Balance Sheet and Statement of Custodial Activity for fiscal year 2011; also, the remainder of its financial statements for fiscal year 2011 (consisting of the Statements of Net Cost, Changes in Net Position, and Budgetary Resources) and all of DHS's financial statements for fiscal year 2010 were not auditable or not subjected to audit by agency auditors. Further, the financial statements of the National Aeronautics and Space Administration for fiscal year 2010 and the Department of State for fiscal years 2011 and 2010 were not fully auditable. Also, in our audit report on the U.S. government's consolidated financial statements for fiscal year 2010, we reported that the financial statements of the Department of Labor (Labor) for fiscal year 2010 were not auditable or not subjected to audit by agency auditors. However, subsequent to our report, the agency's auditors issued an unqualified opinion in a revised audit report on Labor's reissued financial statements for fiscal year 2010. According to the May 2011 auditor's report, Labor's implementation of a new accounting and reporting system hindered its ability to assure the accuracy and completeness of the consolidated financial statement balances that received a disclaimer of opinion in November 2010. Further, the audit report states that Labor was subsequently able to prepare consolidated financial statements and provide sufficient support so that it received an unqualified opinion on its financial statements for fiscal year 2010.

⁷We 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 2006 and on the accrual-based consolidated financial statements of the U.S. government for fiscal years 2007 through 2010.

⁸The valuation date is January 1 for all social insurance programs except the Black Lung program, which has a valuation date of September 30.

The Federal Government's Actions to Stabilize Financial Markets and to Promote Economic Recovery

The accrual-based consolidated financial statements for fiscal year 2011 include, as they did for fiscal year 2010, substantial assets and liabilities resulting from the federal government's actions to stabilize financial markets and to promote economic recovery. Key actions that the federal government has taken to stabilize financial markets and to promote economic recovery are discussed in the Management's Discussion and Analysis section of the *2011 Financial Report* and related Notes to the consolidated financial statements.

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. As of September 30, 2011, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in reported federal government assets of over \$295 billion (e.g., the Troubled Asset Relief Program (TARP) equity investments,⁹ investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and mortgage-backed securities guaranteed by them),¹⁰ which is net of about \$95 billion in valuation losses. In addition, the federal government reported incurring significant liabilities as of September 30, 2011 (e.g., about \$316 billion related to estimated future payments to Fannie Mae and Freddie Mac) resulting from these actions. In valuing these assets and liabilities, management considered and selected assumptions and data that it believed provided a reasonable basis for the estimated values reported in the accrual-based consolidated financial statements. However, as discussed in Note 1 to the consolidated financial statements, there are many factors affecting these 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. As such, there will be differences between the estimated values as of September 30, 2011, and the actual results, and such differences may be material. These differences will also affect the ultimate cost of the federal government's actions.

Long-Term Fiscal Challenges

Although the economy is still fragile, there is wide agreement on the need to take steps to address the federal government's long-term fiscal challenges. The comprehensive long-term fiscal projections presented in this *2011 Financial Report* show that—absent policy changes—the federal government continues to face an unsustainable fiscal path. Largely as a result of the provisions in the Budget Control Act of 2011,¹¹ the fiscal outlook has improved. However, rising health care costs and the aging of the U.S. population continue to create budgetary pressure. The oldest members of the baby boom generation are now eligible for early Social Security retirement benefits and for Medicare benefits. In addition, debt held by the public continues to grow as a share of the economy; this means the current structure of the federal budget is unsustainable over the longer term.

These comprehensive projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective

⁹TARP was established by the Department of the Treasury (Treasury) under authority provided in the Emergency Economic Stabilization Act of 2008 (Pub. L. No. 110-343). The act requires the U.S. Comptroller General to audit TARP's financial statements as well as report every 60 days on a variety of areas associated with oversight of TARP. For the TARP financial statement audits and the 60-day reports, see GAO's website at www.gao.gov.

¹⁰The Housing and Economic Recovery Act of 2008 (Pub. L. No. 110-289) authorized Treasury to purchase, until December 31, 2009, any amount of Fannie Mae or Freddie Mac securities, whether debt or equity.

¹¹Pub. L. No. 112-25, 125 Stat. 240 (Aug. 2, 2011).

throughout the projection period. GAO also prepares long-term fiscal simulations for the U.S. government.¹² Under GAO's Alternative simulation, which modifies the revenue assumptions used in the above noted projections and uses the Centers for Medicare and Medicaid Services (CMS) actuary's alternative health care cost projections, projected spending in excess of receipts would be greater and debt held by the public as a share of gross domestic product (GDP) would grow more quickly than the projections in the *2011 Financial Report*. For example, under GAO's Alternative simulation, debt held by the public as a share of GDP would exceed the historical high reached in the aftermath of World War II by 2027,¹³ 10 years earlier than the projections in the *2011 Financial Report*. The federal government faces increasing pressures, yet a shrinking window of opportunity, for making policy changes regarding these challenges.

Equity Interests in Certain Financial Organizations and Commercial Entities

As discussed in Note 1 to the consolidated financial statements, such financial statements do not include the assets, liabilities, or results of operations of any financial organizations or commercial entities in which Treasury holds either a direct, indirect, or beneficial equity interest. Treasury and the Office of Management and Budget (OMB) have determined that none of these organizations or entities meet the criteria for a federal entity. The federal government's investments in and any liabilities to such organizations and entities, however, are valued and reported on the Balance Sheet.

Disclaimers of Opinion on the Accrual-Based Consolidated Financial Statements

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. government's accompanying accrual-based consolidated financial statements for fiscal years 2011 and 2010, principally resulting from limitations related to certain material weaknesses in internal control over financial reporting and other limitations on the scope of our work, we are unable to, and we do not, express an opinion on such accrual-based consolidated financial statements. As a result of these limitations, readers are cautioned that amounts reported in the accrual-based consolidated financial statements and related notes may not be reliable.

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the accompanying accrual-based consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. The material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by DOD, were properly reported in the accrual-based consolidated financial statements;

¹²GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2011 Update*, GAO-12-28SP (Washington, D.C.: Oct. 24, 2011).

¹³GAO's Alternative simulation incorporates the CMS Office of the Actuary's alternative projections for health care cost growth, which assume physician payments are not reduced as specified under current law and certain cost controls are not maintained over the long term. Also in this simulation, expiring tax provisions other than the Social Security payroll tax reductions are extended to 2021 and the alternative minimum tax exemption amount is indexed to inflation through 2021; revenues are then brought back to the 40-year historical average as a share of GDP. Discretionary spending follows the Congressional Budget Office's baseline for the first 10 years, which reflect the discretionary spending caps in the Budget Control Act of 2011, and thereafter gradually increases to the historical average share of GDP. Automatic procedures in the Budget Control Act of 2011 that reduce spending by \$1.2 trillion are applied to total annual deficits evenly from 2013 to 2021 and remain a constant share of GDP thereafter.

- 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 reported total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain federal entities;
- adequately account for and reconcile intragovernmental activity and balances between federal entities;
- ensure that the federal government's accrual-based consolidated financial statements were (1) consistent with the underlying audited entities' financial statements, (2) properly balanced, and (3) in conformity with GAAP; and
- identify and either resolve or explain material differences between (1) certain components of the budget deficit reported in Treasury's records that are used to prepare the Reconciliation of Net Operating Cost and the Unified Budget Deficit, the Statement of Changes in Cash Balance from Unified Budget and Other Activities, and the Fiscal Projections for the U.S. Government (included in Supplemental Information) and (2) related amounts reported in federal entities' financial statements and underlying financial information and records.

These material weaknesses continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) 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; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an efficient and effective manner. Due to the material weaknesses and other limitations on the scope of our work discussed above, there may also be additional issues that could affect the accrual-based consolidated financial statements that were not identified. Appendix II describes these material weaknesses in more detail and highlights the primary effects of these material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

Disclaimers of Opinion on the Statements of Social Insurance for 2011 and 2010 and Unqualified Opinions for 2009, 2008, and 2007, and Disclaimer of Opinion on the Statement of Changes in Social Insurance Amounts for 2011

Because of significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2011 and 2010 Statements of Social Insurance, we were unable to obtain sufficient evidence to support the amounts presented in the 2011 and 2010 Statements of Social Insurance and the 2011 Statement of Changes in Social Insurance Amounts. Consequently, we are unable to, and we do not, express opinions on the 2011 and 2010 Statements of Social Insurance as well as on the 2011 Statement of Changes in Social Insurance Amounts. The Statement of Social Insurance presents the actuarial present value of the federal government's estimated future revenue to be received from or on behalf of participants and estimated future expenditures to be paid to or on behalf of participants, based on benefit formulas in

current law and using a projection period sufficient to illustrate the long-term sustainability of the social insurance programs.¹⁴

The significant uncertainties, discussed in further detail in Note 26 to the consolidated financial statements, include:

- Medicare projections in the 2011 and 2010 Statements of Social Insurance were based on full implementation of the provisions of the Patient Protection and Affordable Care Act, as amended (PPACA),¹⁵ including a significant decrease in projected Medicare costs from the 2009 Statement of Social Insurance, related to (1) reductions in physician payment rates (totaling almost 30 percent in January 2012) and (2) productivity improvements for most other categories of Medicare providers. However, there are significant uncertainties concerning the achievement of these projected decreases in Medicare costs.
- Management has noted that actual future costs for Medicare are likely to exceed those shown by the current-law projections presented in the 2011 and 2010 Statements of Social Insurance due to the likelihood of modifications to the scheduled reductions.¹⁶ The extent to which actual future costs exceed the projected current-law amounts due to changes to the physician payments and productivity adjustments depends on both the specific changes that might be legislated and on whether legislation would include other provisions to help offset such costs.
- Management has developed an illustrative alternative projection intended to provide additional context regarding the long-term sustainability of the Medicare program and to illustrate the uncertainties in the Statement of Social Insurance projections. The present value of future estimated expenditures in excess of future estimated revenue for Medicare included in the illustrative alternative projection exceeds the \$24.6 trillion estimate in the 2011 Statement of Social Insurance by \$12.4 trillion.

Projections of Medicare costs are sensitive to assumptions about future decisions by policymakers and about the behavioral responses of consumers, employers, and health care providers as policy, incentives, and the health care sector change over time. For example, behavioral responses of health care providers could affect Medicare beneficiaries' access to care. Such secondary impacts are not reflected in the Statement of Social Insurance projections but could be expected to influence the excess cost growth rate¹⁷ used in the projections. Key drivers of uncertainty about the excess cost growth rate include the future development and deployment of medical technology, the evolution of personal income, and the cost and availability of insurance, as well as federal policy change such as the PPACA. The work of the 2010 Technical Review Panel on the Medicare Trustees Report¹⁸ could provide additional guidance to management concerning ways to incorporate secondary impacts into future Statement of Social Insurance projections and related disclosures.

¹⁴The projection period used for the Social Security, Medicare, and Railroad Retirement social insurance programs is 75 years. For the Black Lung program, the projections are through September 30, 2040.

¹⁵Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

¹⁶The Medicare and Medicaid Extenders Act of 2010, Pub. L. No. 111-309, § 101, overrode the scheduled reductions in physician payments through December 2011 and reduced non-Medicare outlays by limiting a health insurance tax credit.

¹⁷The excess cost growth rate is the increase in health care spending per person relative to the growth of GDP per person after removing the effects of demographic changes on health care spending.

¹⁸In August 2010, the Secretary of the Department of Health and Human Services, working on behalf of the Board of Trustees, established an independent panel of expert actuaries and economists to review the assumptions and methods used by the Trustees to make projections of the financial status of the trust funds.

As a result of the uncertainties discussed previously, readers are cautioned that amounts reported in the 2011 and 2010 Statements of Social Insurance and related Notes to such financial statements may not fairly present, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with GAAP. The uncertainties related to the 2011 and 2010 Statements of Social Insurance also affect the projected Medicare and Medicaid costs reported in the Fiscal Projections for the U.S. government, which is presented in Supplemental Information and is summarized in Management's Discussion and Analysis and other accompanying information.

In addition, the Supplemental Information section of the *2011 Financial Report* includes unaudited information concerning how changes in various assumptions would change the present value of future estimated expenditures in excess of future estimated revenue. As discussed in that section, Medicare projections are very sensitive to changes in the health care cost growth assumption.

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 GAAP.

In preparing the Statements of Social Insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statement. However, because of the large number of factors that affect the Statement of Social Insurance and the fact that such assumptions are inherently subject to substantial uncertainty—arising from the likelihood of future changes in general economic, regulatory, and market conditions, as well as other more specific future events, such as legislative changes (e.g., changes in benefits or provider payments), other significant uncertainties, and contingencies—there will be differences between the estimates in the Statement of Social Insurance and the actual results, and those differences may be material. In addition to the inherent uncertainty that underlies the expenditure projections prepared for all parts of Medicare, the Supplementary Medical Insurance Part D projections have an added uncertainty in that they were prepared using very little program experience upon which to base the estimates.

The scheduled future benefits presented in the Statement of Social Insurance are based on benefit formulas in current law. However, consistent with the respective annual Trustees Reports, the Social Security and Medicare programs are not sustainable under current financing arrangements. Also, the law concerning these programs can be changed at any time by the Congress. In fact, payment of Social Security and Medicare Hospital Insurance (Part A) benefits are limited by law to the balances in the respective trust funds. Consequently, future scheduled benefits are limited to future revenues plus existing trust fund assets. As discussed in the Supplemental Information section of the *2011 Financial Report*, the Social Security and Medicare Hospital Insurance (Part A) trust funds are, based on achievement of the cost reductions discussed above, projected to be exhausted in 2036 and 2024, respectively, at which time the full amount of scheduled future benefits will be unable to be paid. For Social Security, projected future revenues as of January 1, 2011 would be sufficient to pay 77 percent of scheduled benefits in 2036, the year of trust fund exhaustion, and decreasing to 74 percent of scheduled benefits in 2085. Similarly, for Medicare Hospital Insurance (Part A), projected future revenues as of January 1, 2011 would be sufficient to pay 90 percent of scheduled benefits in 2024, the year of trust fund exhaustion, declining to 76 percent in 2050 and then increasing to 88 percent of scheduled benefits in 2085.

Other Limitations on the Scope of Our Work

For fiscal years 2011 and 2010, there were limitations on the scope of our work in addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. Treasury and OMB depend on representations from certain federal entities to provide their

representations to us regarding the U.S. government's consolidated financial statements. Treasury and OMB were unable to provide us with adequate representations regarding the U.S. government's accrual-based consolidated financial statements for fiscal years 2011 and 2010 primarily because of insufficient representations provided to them by certain federal entities.

Material Weaknesses Resulted in Ineffective Internal Control over Financial Reporting

The material weaknesses discussed in this report resulted in ineffective internal control over financial reporting. Consequently, the federal government's internal control did not provide reasonable assurance that misstatements, losses, or noncompliance material in relation to the consolidated financial statements would be prevented or detected and corrected on a timely basis. The federal government is responsible for establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness. Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in conformity with GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements.

In planning and performing our audit, we considered internal control over financial reporting. We did not consider all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We do not express an opinion on the effectiveness of internal control over financial reporting because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal control. Based on the scope of our work and the effects of the other limitations on the scope of our audit noted throughout this report, our internal control work would not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.¹⁹

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, which were discussed previously, we found the following three other material weaknesses in internal control. These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments,
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

These material weaknesses are discussed in more detail in appendix III, including the primary effects of the material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

¹⁹A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

We also found two significant deficiencies in the federal government's internal control related to implementing effective internal controls at certain federal entities for the following areas:

- loans receivable and loan guarantee liabilities, which for the most part, involve credit subsidy estimation and related financial reporting processes; and
- federal grants management.

These significant deficiencies are discussed in more detail in appendix IV.

Further, individual federal entity financial statement audit reports identified additional control deficiencies that were reported by the entity's auditors as either material weaknesses or significant deficiencies at the individual entity level. We do not consider these additional deficiencies to represent material weaknesses or significant deficiencies with respect to the consolidated financial statements.

Compliance with Laws and Regulations

Our work to test compliance with selected provisions of laws and regulations that have a direct and material effect on the consolidated financial statements was limited by the material weaknesses and other scope limitations discussed in this report. U.S. generally accepted government auditing standards and OMB guidance require auditors to report on entities' compliance with selected provisions of laws and regulations. Certain individual entity audit reports contain instances of noncompliance. None of these instances were deemed to be reportable noncompliance with regard to the accompanying consolidated financial statements.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with laws and regulations.

Other Information Included in the Financial Report

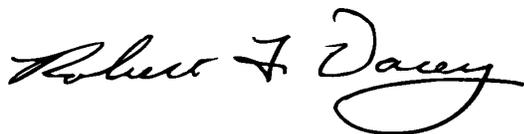
Management's Discussion and Analysis, Stewardship Information, Supplemental Information, and other accompanying information, including the Citizen's Guide, included in the *2011 Financial Report* contain a wide range of information, some of which is not directly related to the consolidated financial statements. We did not audit and we do not express an opinion on this information.

Readers are cautioned that the material weaknesses and scope limitations discussed in this audit report, including those related to our disclaimers of opinion on the 2011 and 2010 Statements of Social Insurance and the 2011 Statement of Changes in Social Insurance Amounts, affect the reliability of certain information contained in the Management's Discussion and Analysis, Stewardship Information, Supplemental Information, and other accompanying information that is taken from the same data sources as the accrual-based consolidated financial statements, the 2011 and 2010 Statements of Social Insurance, and the 2011 Statement of Changes in Social Insurance Amounts.

CFO Act Agency Financial Management Systems

The federal government's ability to efficiently and effectively manage and oversee its day-to-day operations and programs relies heavily on the ability of entity financial management systems²⁰ to produce complete, reliable, timely, and consistent financial information for use by executive branch agencies and the Congress. FFMIA was designed to lead to system improvements that would result in CFO Act agency managers routinely having access to reliable, useful, and timely financial-related information to measure performance and increase accountability throughout the year. FFMIA requires auditors, as part of the 24 CFO Act agencies' financial statement audits, to report whether those agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's Standard General Ledger (SGL) at the transaction level. For fiscal years 2011 and 2010, auditors for 11 and 10 of the 24 CFO Act agencies, respectively, reported that the agencies' financial management systems did not substantially comply with one or more of the three FFMIA requirements. Agency management at the 24 CFO Act agencies also annually report on FFMIA compliance. For both fiscal years 2011 and 2010, agency management at 7 of the CFO Act agencies reported that their agencies' financial management systems were not in substantial compliance with one or more of the three FFMIA requirements. The differences in the assessments of substantial compliance between the auditors and agency management reflected differences in views between management and the auditors on the impact reported deficiencies had on agencies' financial management systems. Long-standing financial management systems weaknesses at several large CFO Act agencies, along with the size and complexity of the federal government, continue to present a formidable management challenge in providing accountability to the nation's taxpayers and have contributed significantly to the material weaknesses and other limitations that have resulted in our disclaimers of opinion on the accrual-based consolidated financial statements.

We provided a draft of this report to Treasury and OMB officials, who provided technical comments, which have been incorporated as appropriate. Treasury and OMB officials expressed their continuing commitment to address the problems this report outlines.



Robert F. Dacey
Chief Accountant
U.S. Government Accountability Office

December 12, 2011

²⁰The term financial management systems includes the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

APPENDIX I

Objective, Scope, and Methodology

Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2011 and 2010, including the new Statement of Changes in Social Insurance Amounts for 2011, and the 2009, 2008, and 2007 Statements of Social Insurance, along with reporting on internal control over financial reporting and on compliance with selected provisions of laws and regulations.

The Government Management Reform Act of 1994 expanded the requirements of the Chief Financial Officers (CFO) Act of 1990 by making the inspectors general of 24 major federal agencies²¹ responsible for annual audits of agencywide financial statements prepared by these agencies and GAO responsible for the audit of the U.S. government's consolidated financial statements. The Accountability of Tax Dollars (ATD) Act of 2002²² requires most other executive branch entities to prepare and have audited annual financial statements. The Office of Management and Budget (OMB) and the Department of the Treasury (Treasury) have identified 35 federal entities²³ that are significant to the U.S. government's consolidated financial statements, consisting of the 24 CFO Act agencies, several other federal executive branch agencies, and some government corporations (35 significant entities). Our work was performed in coordination and cooperation with the inspectors general and independent public accountants for these 35 significant entities to achieve our respective audit objectives. Our audit approach regarding the accrual-based consolidated financial statements focused on determining the current status of the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements and the other material weaknesses affecting internal control that we had reported in our report on the consolidated financial statements for fiscal year 2010.²⁴ We also separately audited the financial statements of certain federal entities and federal agency components including the following:

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2011 and 2010 financial statements.²⁵ In fiscal years 2011 and 2010, IRS collected about \$2.4 trillion and \$2.3 trillion, respectively, in tax payments and paid about \$416 billion and \$467 billion, respectively, in refunds to taxpayers. For fiscal year 2011, we continued to report material weaknesses that resulted in ineffective internal control over financial reporting. In addition, we continued to find a significant deficiency in IRS's internal control over tax refund disbursements, which resulted in the payment of erroneous tax refunds to taxpayers. Our tests of IRS's compliance in fiscal year 2011 with selected provisions of laws and regulations disclosed one area of noncompliance. We also found that IRS's financial management systems did not substantially comply with the requirements of FFMIA.
- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2011 and 2010.²⁶ For these 2 fiscal years, the Schedules reported (1) approximately \$10.1 trillion (2011) and

²¹31 U.S.C. 901(b), 3521(e). The 1994 act authorized the Office of Management and Budget to designate agency components that also would receive a financial statement audit. See 31 U.S.C. 3515(c).

²²Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002); see 31 U.S.C. 3515.

²³See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 entities.

²⁴For our report on the U.S. government's consolidated financial statements for fiscal year 2010, see U.S. Department of the Treasury, *2010 Financial Report of the United States Government* (Washington, D.C.: December 2010), pp. 221-249, which can be found on GAO's website at www.gao.gov/financial.html.

²⁵GAO, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements*, GAO-12-165 (Washington, D.C.: Nov. 10, 2011).

²⁶GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2011 and 2010 Schedules of Federal Debt*, GAO-12-164 (Washington, D.C.: Nov. 8, 2011).

\$9.0 trillion (2010) of federal debt held by the public;²⁷ (2) about \$4.7 trillion (2011) and \$4.5 trillion (2010) of intragovernmental debt holdings;²⁸ and (3) about \$251 billion (2011) and \$215 billion (2010) of interest on federal debt held by the public. We reported that as of September 30, 2011, BPD had effective internal control over financial reporting relevant to the Schedule of Federal Debt. Further, we reported that we found no reportable noncompliance in fiscal year 2011 with selected provisions of laws related to the Schedules of Federal Debt we tested.

- We audited and expressed unqualified opinions on the fiscal years 2011 and 2010 financial statements of the United States Securities and Exchange Commission (SEC) and its Investor Protection Fund (IPF).²⁹ We also reported that as of September 30, 2011, although internal controls could be improved, SEC had effective internal control over financial reporting for both the entity as a whole and the IPF. In addition, we reported that we found no reportable noncompliance for either SEC or IPF in fiscal year 2011 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the fiscal years 2011 and 2010 financial statements of the Federal Housing Finance Agency (FHFA).³⁰ We reported that FHFA had effective internal control over financial reporting as of September 30, 2011, and we found no reportable noncompliance in fiscal year 2011 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the Office of Financial Stability's (OFS) fiscal years 2011 and 2010 financial statements for the Troubled Asset Relief Program (TARP).³¹ We reported that although certain internal controls could be improved, OFS had effective internal control over financial reporting as of September 30, 2011. We also reported that we found no reportable noncompliance for fiscal year 2011, with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the fiscal year 2011 financial statements of the Bureau of Consumer Financial Protection (CFPB).³² We reported that CFPB had effective internal control over financial reporting as of September 30, 2011, and we found no reportable noncompliance for fiscal year 2011 with the selected provisions of laws and regulations we tested.
- We audited and expressed unqualified opinions on the December 31, 2010 and 2009, financial statements of two funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Deposit Insurance Fund (DIF) and the Federal Savings and Loan Insurance Corporation

²⁷The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, foreign governments, and central banks.

²⁸Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.

²⁹GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2011 and 2010*, GAO-12-219 (Washington, D.C.: Nov. 15, 2011).

³⁰GAO, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2011 and 2010 Financial Statements*, GAO-12-161 (Washington, D.C.: Nov. 15, 2011).

³¹GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Years 2011 and 2010 Financial Statements*, GAO-12-169 (Washington, D.C.: Nov. 10, 2011).

³²GAO, *Financial Audit: Bureau of Consumer Financial Protection's Fiscal Year 2011 Financial Statements*, GAO-12-186 (Washington, D.C.: Nov. 15, 2011). CFPB was established in Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, Title X, 124 Stat. 1376, 1955 (July 21, 2010), as the federal entity charged with the responsibility of regulating the offering and provision of consumer financial products or services under the federal consumer financial laws. While CFPB began operations in 2010, fiscal year 2011 was its first full year of operations and the first year for which it prepared financial statements. Consequently, CFPB's fiscal year 2011 financial statements do not present comparative information for the prior year.

(FSLIC) Resolution Fund.³³ We reported that as of December 31, 2010, FDIC had effective internal control over financial reporting, and we found no reportable noncompliance for calendar year 2010 with the selected provisions of laws and regulations we tested.

In addition, we considered the CFO Act agencies' and certain other federal entities' fiscal years 2011 and 2010 financial statements and the related auditors' reports prepared by the inspectors general or contracted independent public accountants. Financial statements and audit reports for these significant entities provide information about the operations of each of these entities. The entity audit reports also contain details regarding any audit findings and related recommendations for the respective entity. We did not audit, and we do not express an opinion on, any of these individual federal entity financial statements.

We considered the Department of Defense's (DOD) assertion in the *DOD Agency Financial Report for Fiscal Year 2011* regarding its noncompliant financial systems and lack of reasonable assurance that internal controls over financial reporting were effective. In addition, in the DOD Inspector General's fiscal year 2011 report on internal control over financial reporting, the Inspector General cited material weaknesses in several areas including (1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations; and (5) material amounts of unsupported accounting entries needed to prepare DOD's annual consolidated financial statements.

Because of the significance of the amounts presented in the Statement of Social Insurance and Statement of Changes in Social Insurance Amounts related to the Social Security Administration (SSA) and the Department of Health and Human Services (HHS), our audit approach regarding these statements focused primarily on these two agencies. For each federal entity preparing a Statement of Social Insurance and Statement of Changes in Social Insurance Amounts,³⁴ we considered the entity's 2011, 2010, 2009, 2008, and 2007 Statements of Social Insurance and the 2011 Statement of Changes in Social Insurance Amounts as well as the related auditor's reports prepared by the inspectors general or contracted independent public accountants. We believe our audit, including internal control and substantive audit procedures, reperformance procedures, and review of the other auditors' Statement of Social Insurance-related audit work, provides a reasonable basis for our opinions on the 2009, 2008, and 2007 Statements of Social Insurance.

We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and compliance with selected provisions of laws and regulations. We considered the limitations on the scope of our work regarding the accrual-based consolidated financial statements, the 2011 and 2010 Statements of Social Insurance, and the 2011 Statement of Changes in Social Insurance Amounts in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

³³GAO, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2010 and 2009 Financial Statements*, GAO-11-412 (Washington, D.C.: Mar. 18, 2011).

³⁴These entities consist of SSA, HHS, the Railroad Retirement Board, and the Department of Labor.

APPENDIX II

Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual-Based Consolidated Financial Statements

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual-based consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the accompanying accrual-based 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 accrual-based 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. Certain entities reported continued deficiencies in internal control procedures and processes related to PP&E.

Deficiencies in internal control over such assets could affect the federal government's ability to fully know the assets it owns, including their location and condition, and its ability to effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets and reliably report asset balances; (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 any related to treaties and other international agreements entered into to further the federal 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, deficiencies in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as adversely 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, to the extent disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

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 entities affected reported net costs. As a result, the federal government was unable to support significant portions of the reported total net cost of operations, most notably those related to DOD.

With respect to disbursements, DOD and certain other federal entities reported continued material weaknesses and significant deficiencies in reconciling disbursement activity. For fiscal years 2011 and 2010, there was unreconciled disbursement activity, including unreconciled differences between federal entities' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal entity 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 or authorized. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal entities for inclusion in *The Budget of the United States Government* (President's Budget) concerning obligations and outlays.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Although progress has been made, federal entities continue to be 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 significant entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these entities are required to report to Treasury, the entity's inspector general, and GAO on the extent and results of intragovernmental activity and balance-reconciliation efforts as of the end of the fiscal year.

A substantial number of the entities did not adequately perform the required year-end reconciliations for fiscal years 2011 and 2010. For these fiscal years, based on trading partner information provided to Treasury in the 35 significant entities' closing packages, Treasury provided a *Material Differences Report* to each entity showing amounts for certain intragovernmental activity and balances that significantly differed from those of the entity's corresponding trading partners as of the end of the fiscal year. Entities are required to complete their *Material Differences Reports*, which includes providing explanations of the reasons for certain differences. Based on our review of completed *Material Differences Reports* for fiscal year 2011, we continue to note that amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. We noted that a significant number of CFOs continue to cite differing accounting methodologies, accounting errors, and timing differences for material differences with their trading partners. Some CFOs indicated that they did not know the reason for the differences. In addition, some CFOs confirmed the balance or activity, however, differences continued to exist. Further, there continue to be hundreds of billions of dollars of unreconciled differences between the General Fund of the U.S. Government and federal entity trading partners related to appropriation and other intragovernmental transactions. The ability to reconcile such transactions is hampered because only some of the General Fund of the U.S. Government is reported in the Department of the Treasury's financial statements. As a result of these circumstances, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

During fiscal year 2011, Treasury furthered its commitment to resolve differences in intragovernmental activity and balances, which included several short- and long-term initiatives. For example, Treasury expanded focus groups' monitoring and outreach efforts that included quarterly analysis and ongoing collaboration with entities to resolve intragovernmental differences.³⁵ Such focus groups made significant progress in understanding reasons for material differences and determining corrective actions to be taken, which resulted in adjustments to eliminate certain differences. Also, Treasury identified deficiencies in the intragovernmental process and is planning to develop government-wide systems to improve intragovernmental transactions data. Further, Treasury is currently working to develop a complete set of financial statements for the General Fund, including intragovernmental transactions. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong and sustained commitment by federal entities, as well as continued strong leadership by OMB and Treasury.

Preparation of Consolidated Financial Statements

While Treasury, in coordination with OMB, implemented corrective actions during fiscal year 2011 to address certain internal control deficiencies detailed in our previously issued report, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). During our fiscal year 2011 audit, we found the following:³⁶

- Treasury's process for compiling the consolidated financial statements generally demonstrated that amounts in the Statement of Social Insurance and the Statement of Changes in Social Insurance Amounts were consistent with the underlying federal entities' financial statements and that the Balance Sheet and the Statement of Net Cost were also consistent with the 35 significant federal entities' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process did not ensure that the information in the remaining three principal financial statements was fully consistent with the underlying information in the 35 significant federal entities' audited financial statements and other financial data.
- For fiscal year 2011, auditors reported significant internal control deficiencies at several entities that impacted the preparation of the respective entities' closing packages. Further, Treasury had to record significant adjustments to correct errors found in federal entities' audited closing package information. To ensure consistency of underlying entity information and financial data with the U.S. government's consolidated financial statements, entity auditors are required to separately audit and report on the financial information sent by the 35 significant federal entities to Treasury through closing packages.
- Treasury is unable to fully identify and quantify all components of unreconciled activities. To make the fiscal years 2011 and 2010 consolidated financial statements balance, Treasury recorded net increases of \$15.6 billion and \$0.8 billion, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which were identified as "Unmatched transactions and

³⁵Beginning in 2008, Treasury established three focus groups to work with federal entity personnel to identify and resolve reported differences related to benefits, transfers, and buy/sell transactions.

³⁶Most of the issues we identified in fiscal year 2011 existed in fiscal year 2010, and many have existed for a number of years. Most recently, in May 2011, we reported the issues we identified to Treasury and OMB and provided recommendations for corrective action in GAO, *Management Report: Improvements Needed in Controls over the Preparation of the U.S. Consolidated Financial Statements*, GAO-11-525 (Washington, D.C.: May 26, 2011).

balances.”³⁷ Treasury recorded an additional net \$6.0 billion and \$3.8 billion of unmatched transactions in the Statement of Net Cost for fiscal years 2011 and 2010, respectively.

- The federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the accrual-based consolidated financial statements. Treasury’s elimination of certain intragovernmental activity and balances continues to be impaired by the federal entities’ problems in handling their intragovernmental transactions. As a result, Treasury recorded the net differences in intragovernmental elimination entries as part of the “Unmatched transactions and balances” discussed above.
- The federal government could not demonstrate that it had fully identified and reported all items needed to reconcile the operating results to the budget results. Typical reconciling items would include both accrual-based costs that are not yet recognized in the unified budget deficit and budget costs that are not yet recognized in the net operating cost.
- The federal government has not established and implemented effective processes and procedures for identifying and reporting all items needed to prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities.
- Over the past several years, significant actions have been taken to assist in ensuring that financial information is reported or disclosed in the consolidated financial statements in conformity with GAAP. However, Treasury’s reporting of certain financial information required by GAAP continues to be impaired. Due to certain control deficiencies noted in this report—for example, commitments and contingencies related to treaties and other international agreements—Treasury is precluded from determining if additional disclosure is required by GAAP in the consolidated financial statements, and we are precluded from determining whether the omitted information is material. Further, Treasury’s ability to report information in conformity with GAAP will also remain impaired until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.
- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal entities 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 that the excluded financial information was immaterial.
- Other internal control deficiencies existed in the process for preparing the consolidated financial statements, involving (1) inadequate design and ineffective implementation of policies and procedures related to certain areas, and (2) inadequate processes for monitoring and assessing internal controls over the preparation of the consolidated financial statements. As a result, we identified numerous errors in draft consolidated financial statements that were subsequently corrected.
- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2011 financial reporting challenges it faced, such as control deficiencies in its process for preparing the consolidated financial statements noted above. We found that personnel at Treasury’s Financial Management Service had excessive workloads that required an extraordinary

³⁷Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to net operating cost, it reported this amount as a component of net operating cost in the accompanying consolidated financial statements.

amount of effort and dedication to compile the consolidated financial statements. Further, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. In addition, the federal government does not perform interim compilations at the governmentwide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year.

Until these internal control deficiencies have been fully addressed, the federal government's ability to ensure that the consolidated financial statements are consistent with the underlying audited federal entities' financial statements, properly balanced, and in conformity with U.S. GAAP will be impaired. Resolving some of these internal control deficiencies will be a difficult challenge and will require a strong and sustained commitment from Treasury and OMB as they continue to execute and implement their corrective action plans.

Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and the Statement of Changes in Cash Balance from Unified Budget and Other Activities report a unified budget deficit for fiscal years 2011 and 2010 of about \$1.3 trillion and \$1.3 trillion, respectively.³⁸ The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts). Also, the Fiscal Projections for the U.S. Government included in Supplemental Information use such outlays and receipts.

For several years, we have been reporting significant unreconciled differences between the total net outlays reported in selected federal entities' Statements of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit³⁹ reported in the consolidated financial statements. Unreconciled net outlays of about \$31 billion and \$40 billion existed for fiscal years 2011 and 2010, respectively. OMB and Treasury have recognized that it will take a coordinated effort to establish effective processes and procedures for identifying, resolving, and explaining material differences in this and other components of the deficit between Treasury's central accounting records and information reported in entity financial statements and underlying entity financial information and records. Until these types of differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will continue to be unknown.

In fiscal year 2011, we again noted that several entities' auditors reported internal control deficiencies (1) affecting the entities' SBRs and (2) related to monitoring, accounting, and reporting of budgetary transactions. These control deficiencies could affect the reporting and calculation of the net outlay amounts in the entities' SBRs. In addition, such deficiencies may also affect the entities' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget deficit reported in the accrual-based consolidated financial statements. The unified budget deficit is also reported by Treasury in its *Combined Statement of Receipts, Outlays, and Balances*,⁴⁰ and in other federal government publications.

³⁸The budget deficit, receipts, and outlays amounts are reported in Treasury's *Monthly Treasury Statement* and the President's Budget.

³⁹See GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).

⁴⁰Treasury'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 entity reporting.

APPENDIX III

Other Material Weaknesses

Material weaknesses in internal control discussed in this report resulted in ineffective controls over financial reporting. In addition to the material weaknesses discussed in appendix II that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, we found the following three other material weaknesses in internal control.

Improper Payments

During fiscal year 2011, the federal government continued to make progress in reporting on improper payments. Entities reported on 12 additional programs' improper payments estimated amounts in fiscal year 2011 when compared to fiscal year 2010.⁴¹ Most notably, the Department of Health and Human Services (HHS) reported an estimated improper payment amount for Medicare Part D of \$1.7 billion. Nevertheless, the federal government continues to face challenges in determining the full extent of improper payments. For example, 3 federal entities did not report fiscal year 2011 estimated improper payment amounts for 4 risk-susceptible programs, including HHS's Children's Health Insurance Program and Temporary Assistance for Needy Families. The Improper Payments Information Act of 2002 (IPIA),⁴² as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA),⁴³ requires federal executive branch entities to (1) review all programs and activities, (2) identify those that may be susceptible to significant improper payments,⁴⁴ (3) estimate and report the annual amount of improper payments for those programs, and (4) implement actions to reduce improper payments. IPERA also established additional requirements related to recovery auditing. OMB issued implementing guidance in fiscal year 2011.

Federal entities reported estimates of improper payment amounts that totaled \$115.3 billion in fiscal year 2011, a decrease from the prior year revised estimate of \$120.6 billion.⁴⁵ These estimates represented about 4.7 percent and 5.3 percent of reported outlays for the associated programs in fiscal years 2011 and 2010, respectively. Decreases in reported estimates of improper payments were mostly attributable to three major programs: (1) Department of Labor's Unemployment Insurance program, (2) Department of the Treasury's Earned Income Tax Credit Program, and (3) HHS' Medicare Advantage program. The decreases in the estimates for these programs primarily related to a decrease in reported outlays for the Unemployment Insurance program and decreases in reported error rates⁴⁶ for the Earned Income Tax Credit and Medicare Advantage programs. It is important to note that reported improper payment estimates include overpayments, underpayments, and payments for which adequate documentation was not found, and may also include amounts of payments for years prior to the current fiscal year.

⁴¹Of the 12 programs, 3 programs have been excluded from the governmentwide totals to avoid distortion of the governmentwide error rate because those programs were refining their estimating methodologies.

⁴²Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

⁴³Pub. L. No. 111-204, 124 Stat. 2224 (July 22, 2010).

⁴⁴Improper payments are defined 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 good or service, any duplicate payment, any payment for good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts.

⁴⁵In their fiscal year 2011 Performance and Accountability Reports (PAR) and Annual Financial Reports (AFR), 4 federal entities updated their fiscal year 2010 improper payment estimates to reflect changes since issuance of their fiscal year 2010 PARs and AFRs. These updates decreased the governmentwide improper payment estimate for fiscal year 2010 from \$125.4 billion to \$120.6 billion.

⁴⁶Reported error rates reflect the estimated improper payments as a percentage of total program outlays.

Entity auditors reported some internal control deficiencies over financial reporting, such as financial system limitations and information system control weaknesses, that significantly increase the risk that improper payments may occur and not be detected promptly. Until the federal government has implemented effective processes to determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken across entities and programs to effectively reduce improper payments, the federal government will not have reasonable assurance that the use of taxpayer funds is adequately safeguarded.

Information Security

Although progress has been made, serious and widespread information security control deficiencies reported during fiscal year 2011 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. Specifically, control deficiencies were identified related to (1) security management; (2) access to computer resources (data, equipment, and facilities); (3) changes to information system resources; (4) segregation of incompatible duties; and (5) contingency planning. We have reported information security as a high-risk area across government since February 1997.

Such information security control deficiencies unnecessarily increase the risk that the reliability and availability of data that are recorded in or transmitted by federal financial management systems could be compromised. A primary reason for these deficiencies is that federal entities generally have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control deficiencies, resolving information security problems, and managing information security risks on an ongoing basis. The federal government has taken important actions to improve information security, such as deploying continuous monitoring capabilities, and enhancing performance measures and reporting processes. However, until entities identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2011, material weaknesses and systemic deficiencies continued to affect the federal government's ability to effectively manage its tax collection activities. Due to errors and delays in recording taxpayer information, assessments, payments, and other activities, the federal government's records did not always reflect the correct amount that taxpayers owed and this contributed to the federal government's inability to timely release federal tax liens against taxpayers who fully satisfied or were otherwise relieved of their tax liability. Such errors and delays may cause undue burden and frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts. In addition, deficiencies in internal control over tax refunds increased the risk of the federal government issuing duplicate or otherwise erroneous tax refunds to which individuals or businesses are not entitled. Collectively, these deficiencies indicate that internal controls over the financial reporting process were not effective in (1) ensuring that reported amounts of taxes receivable and tax assessments were accurate on an ongoing basis and could be relied upon by management as a tool to aid in making and supporting resource allocation decisions; (2) supporting timely and reliable financial statements, accompanying notes, and required supplemental and other accompanying information without extensive supplemental procedures and adjustments; and (3) safeguarding the federal government's resources.

APPENDIX IV

Significant Deficiencies

In addition to the material weaknesses discussed in appendices II and III, we found two significant deficiencies in the federal government's internal control related to implementing effective internal controls at certain federal entities, as described below. Also, the significant deficiency in fiscal year 2010 relating to deficiencies in certain controls over spreadsheets used by the Department of Health and Human Services (HHS) to prepare its Statement of Social Insurance is no longer considered to be a significant deficiency as of September 30, 2011. HHS, which administers the Medicare programs, contributes the majority of the amounts reported on the consolidated Statement of Social Insurance.

Loans Receivable and Loan Guarantee Liabilities

Internal control deficiencies were identified at certain federal entities accounting for the majority of the reported balances for loans receivable and a significant amount of the reported balances for loan guarantee liabilities. The deficiencies, for the most part, involved credit subsidy estimation and related financial reporting processes. The issues and the complexities associated with estimating the costs of lending and other loan-related financing activities significantly increase the risk that misstatements in entity and governmentwide financial statements could occur and go undetected. Further, these control deficiencies can 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.

Federal Grants Management

The federal government reported grant outlays to states and local governments of over \$600 billion in fiscal year 2010—almost one-fifth of the fiscal year 2010 federal budget. In fiscal year 2011, federal grants management internal control deficiencies, primarily regarding inadequate monitoring and oversight of grant programs, were identified at several federal entities. For example, the auditor for one federal entity that awards and manages significant amounts of grants reported issues regarding action and follow-up with noncompliant grantees, as well as inadequate procedures to identify noncompliant grantees. These internal control deficiencies could adversely affect the federal government's ability to ensure that grant funds are being spent in accordance with applicable program laws and regulations.

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