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Comptroller General
of the United States

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

During fiscal year 2011, the federal government continued to face economic and fiscal challenges in a slow growth economy with high unemployment. Dealing with the government's longer-term fiscal challenge will, as discussed below, require sustained attention and difficult decisions to address serious deficit and debt issues. These fiscal issues further highlight the need for the federal government to operate as effectively and efficiently as possible. Therefore, the Congress, the administration, and federal managers must have ready access to reliable and complete financial and performance information for individual federal entities and the federal government as a whole. Even though significant progress has been made in federal financial management since the enactment of key 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.

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 2011 and 2010 accrual-based consolidated financial statements.[1] About 35 percent of the federal government's reported total assets as of September 30, 2011, and approximately 21 percent of the federal government's reported net cost for fiscal year 2011 relate to the Department of Defense (DOD), which received a disclaimer on its consolidated financial statements, and the Department of Homeland Security (DHS), which received a qualified opinion on its Balance Sheet and Statement of Custodial Activity for fiscal year 2011 with the remainder of its financial statements being unaudited.

[1]The 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. Two additional statements that do not interrelate with the accrual-based consolidated financial statements are also included: the Statements of Social Insurance, and the Statement of Changes in Social Insurance Amounts, and related notes.

- Because of significant uncertainties, primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2011 and 2010 Statements of Social Insurance, we are unable to, and we do not, express an opinion on the 2011 and 2010 Statements of Social Insurance, as well as on the 2011 Statement of Changes in Social Insurance Amounts. About $24.6 trillion, or 72.6 percent, of the federal government's reported total present value of future expenditures in excess of future revenue for 2011 relate to the Department of Health and Human Service's 2011 Statement of Social Insurance, which received a disclaimer of opinion.[2]

- Material weaknesses resulted in ineffective internal control over financial reporting.

- 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 our report.

While significant progress has been made in improving federal financial management since the federal government began preparing consolidated financial statements 15 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: (1) serious financial management problems at the DOD that have prevented its 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.

It is important to emphasize that while the vast majority of the 24 CFO Act agencies received unqualified opinions, DOD and DHS have consistently been unable to receive such audit opinions. Efforts are underway at both agencies to address this situation. At DOD, following years of unsuccessful financial improvement efforts, the Comptroller established the Financial Improvement and Audit Readiness (FIAR) Directorate to develop, manage, and implement a strategic approach for addressing weaknesses and for achieving auditability, and to integrate those efforts with other improvement activities, such as the department's business system modernization efforts. DOD's current FIAR strategy and methodology is to focus on two priorities—budgetary information and asset accountability—with an overall goal of preparing auditable financial statements by September 30, 2017.[3] Because budgetary information is widely and regularly used for management, the Comptroller designated as one of DOD's highest interim priorities the improvement of its budgetary information and processes underlying its Statement of Budgetary Resources (SBR). On October 13, 2011, the Secretary of Defense directed the department to accelerate its audit readiness timelines to achieve audit readiness on DOD components' SBR by fiscal year 2014, and planning for this accelerated goal is underway.

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[2]We issued an unqualified opinion on the Statements of Social Insurance for 2009, 2008, and 2007.

[3]Section 1003 of the National Defense Authorization Act for Fiscal Year 2010 (Pub. L. No. 111-84) made the development and maintenance of the FIAR Plan into a statutory requirement. Under the act, the FIAR Plan must ensure that DOD's financial statements are validated as ready for audit by September 30, 2017.

DHS was able to attain a qualified audit opinion on its fiscal year 2011 Balance Sheet and Statement of Custodial Activity. This is a significant achievement for DHS. However, the remaining statements are unaudited. The auditor was unable to form an opinion on DHS's internal control over financial reporting due to pervasive material internal control weaknesses over key financial reporting processes. It is important that DHS continue to remediate its internal control deficiencies and build upon the progress it has accomplished as it moves forward to expand the audit to all the financial statements and achieve its ultimate goal of obtaining a clean audit opinion on the full set of financial statements and on internal control over financial reporting.

In addition to the material weaknesses underlying the three aforementioned major impediments, we identified three other material weaknesses. These entail the federal government's inability to (1) determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments, (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and (3) effectively manage its tax collection activities. Additional details concerning these material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations are presented in our report. 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 last economic recession and the federal government's actions to stabilize financial markets and promote economic recovery, among other factors, continued to significantly affect the federal government's financial condition. The federal government reported a net operating cost of about $1.3 trillion and a unified budget deficit of approximately $1.3 trillion for fiscal year 2011, and as of September 30, 2011, debt held by the public increased to 68 percent of gross domestic product (GDP). As of September 30, 2011, the federal government's actions to stabilize the financial markets and to promote economic recovery also resulted in reported federal government assets of over $295 billion, which is net of about $95 billion in valuation losses. In addition, the federal government reported incurring significant liabilities 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 2011 include approximately $133 billion of investments in Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) (net of about $43 billion in valuation losses), and approximately $316 billion of liabilities for future payments to these entities. The notes to these financial statements also discuss an estimated additional $60 billion of future payments that could be incurred under an "extreme case" scenario, based on the estimates as of September 30, 2011. Challenges in the housing market have continued and the future structures of these government-sponsored enterprises and the roles they will serve in the mortgage markets must still be determined.

- The federal government reported Troubled Asset Relief Program direct loans and equity investments of approximately $80 billion as of September 30, 2011 (net of about $42 billion in valuation losses, including about $21 billion related to the American International Group, Inc. Investment Program, and approximately $19 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 liabilities of approximately $47 billion as of September 30, 2011, related to estimated failures of insured financial institutions, guarantees, and bank resolutions. Additional losses could occur if economic and market conditions deteriorate in the future.

- 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 approximately $36 billion as of September 30, 2011.

- The federal government reported that the Pension Benefit Guaranty Corporation's (PBGC) liabilities exceeded its assets by about $26 billion as of September 30, 2011. 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 2012 and later. Looking ahead, the federal government will face the challenge of determining the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns.

The comprehensive long-term fiscal projections presented in this *2011 Financial Report of the United States Government* (*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,[4] 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 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 throughout the projection period. GAO also prepares long-term fiscal simulations for the U.S. government.[5] 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 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

[4]Pub. L. No. 112-25, 125 Stat. 240 (Aug. 2, 2011).
[5]GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2011 Update*, GAO-12-28SP (Washington, D.C.: Oct. 24, 2011).

high reached in the aftermath of World War II by 2027,[6] 10 years earlier than the projections in the *2011 Financial Report*.

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 211. Our guide[7] 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 website at www.gao.gov. In addition, the website includes a guide[8] to understanding the differences between accrual and cash measures of the deficit and provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.

[6]GAO'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.
[7]GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-946SP (Washington, D.C.: September 2009).
[8]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*, and GAO-07-117SP (Washington, D.C.: December 2006). In January 2007 and 2008, we issued updates to this guide for fiscal years 2006 and 2007; see GAO-07-341SP (Washington, D.C.: January 2007) and GAO-08-410SP (Washington, D.C.: January 2008).

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

Gene L. Dodaro
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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