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FISCAL YEAR 2011 U.S. GOVERNMENT FINANCIAL STATEMENTS

The Federal Government Faces Continuing Financial Management and Long-Term Fiscal Challenges

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GAO-12-444T

Highlights

Highlights of GAO-12-444T, a testimony before the Subcommittee on Government Organization, Efficiency and Financial Management, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

GAO annually audits the consolidated financial statements of the U.S. government. The Congress and the President need reliable, useful, and timely financial and performance information to make sound decisions and conduct effective oversight of federal government programs and policies.

However, over the years, certain material weaknesses in internal control over financial reporting have prevented GAO from expressing an opinion on the accrual-based consolidated financial statements. Unless these weaknesses are adequately addressed, they will, among other things, continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (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.

This testimony presents the results of GAO's audit for fiscal year 2011 and discusses certain of the federal government's significant long-term fiscal challenges.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management. The federal government has generally taken or plans to take actions to address GAO's recommendations.

View GAO-12-444T. For more information, contact Robert F. Dacey or Gary T. Engel at (202) 512-3406.

March 1, 2012

FISCAL YEAR 2011 U.S. GOVERNMENT FINANCIAL STATEMENTS

The Federal Government Faces Continuing Financial Management and Long-Term Fiscal Challenges

What GAO Found

Three long-standing major impediments continued to prevent GAO from expressing an opinion on the federal government's 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 audited, (2) federal entities' inability to adequately account for and reconcile intragovernmental activity and balances, and (3) the federal government's ineffective process for preparing the consolidated financial statements. GAO also reported material weaknesses involving billions of dollars in improper payments, information security, and tax collection activities. Also, GAO was prevented from expressing opinions on the 2011 and 2010 Statements of Social Insurance and the 2011 Statement of Changes in Social Insurance Amounts because of significant uncertainties primarily related to the achievement of projected reductions in Medicare cost growth reflected in the statements.

GAO is encouraged by the commitment of DOD leaders to improving DOD's financial management and achieving auditability and by the congressional attention being given to this important matter. The Congress set statutory deadlines for DOD auditability, convened a congressional panel to focus on the issue, and held several hearings on DOD financial management. The Secretary of Defense accelerated the timeline for DOD auditability, setting a 2014 deadline for audit readiness of the Statement of Budgetary Resources, and DOD has issued a plan for meeting that date, which GAO is in the process of reviewing. The plan emphasizes the importance of leadership, including senior leaders and field commanders, to achieving DOD's goals, and it links accountability to performance appraisals. To meet their financial management and auditability goals, DOD and its components will need to overcome significant challenges, including implementation of its financial improvement plan, deployment of supporting automated systems, and assessment and resolution of gaps in workforce skills.

The Department of the Treasury (Treasury) furthered its commitment to resolve unreconciled differences between federal entities regarding intragovernmental activity and balances, which included several short- and long-term initiatives. In addition, Treasury, in coordination with the Office of Management and Budget (OMB), implemented corrective actions during 2011 to address certain deficiencies regarding the preparation of the consolidated financial statements. Fully addressing the numerous issues in these areas will require a strong and sustained commitment by federal entities and leadership by Treasury and OMB.

The 2011 Financial Report of the United States Government included comprehensive long-term fiscal projections for the U.S. government, which provides a much needed perspective on the federal government's long-term fiscal position and outlook. These, like GAO's simulations, include the savings provided by the Budget Control Act of 2011. While assuming that the savings as a share of gross domestic product continue beyond the decade leads to an improvement in the long-term fiscal path, it does not make the path sustainable. Addressing the long-term fiscal imbalance is made more difficult by the need to balance achieving the goals of sustaining economic growth in the near term, while producing a plan to change the federal government's long-term fiscal path.

Mr. Chairman, Ranking Member Towns, and Other Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2011 and 2010. 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 long-term fiscal challenges will 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. I would like to commend you, Mr. Chairman, and this Subcommittee, for continuing the annual tradition of oversight hearings on this important subject. Your involvement is critical to assuring continued progress.

Our testimony today discusses the following major issues relating to the consolidated financial statements for fiscal years 2011 and 2010: (1) the results of our audit, including continued major impediments to an opinion on the accrual-based consolidated financial statements[1] and certain significant uncertainties that prevented us from expressing opinions on

[1] The consolidated financial statements other than the Statement of Social Insurance and the Statement of Changes in Social Insurance Amounts are referred to as the accrual-based consolidated financial statements. Most revenues reported in the accrual-based consolidated financial statements are recorded on a modified cash basis. 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. Neither the Statement of Social Insurance nor the Statement of Changes in Social Insurance Amounts interrelate with the accrual-based consolidated financial statements.

the 2011 and 2010 Statements of Social Insurance,[2] as well as on the 2011 Statement of Changes in Social Insurance Amounts; (2) the effects of the last economic recession and the federal government's actions to stabilize financial markets and promote economic recovery on the federal government's financial condition; and (3) challenges posed by the federal government's long-term fiscal outlook.

Both the consolidated financial statements and our related audit report are included in the fiscal year *2011 Financial Report of the United States Government* (*Financial Report*).[3] We performed sufficient audit work to provide our 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 in forming our conclusions. We conducted our audit in accordance with U.S. generally accepted government auditing standards. Our audit report 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 agencies. The *Financial Report* is available at http://www.gao.gov/financial/fy2011financialreport.html and through the Department of the Treasury (Treasury) at http://www.fms.treas.gov/fr/index.html.

[2] Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

[3] Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-946SP (Washington, D.C.: September 2009).

Results of Our Audit of the U.S. Government's Consolidated Financial Statements for Fiscal Years 2011 and 2010

The federal government was unable to demonstrate the reliability of significant portions of the U.S. government's 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. As a result, we were unable to provide an opinion on such statements. Further, significant uncertainties, primarily related to the achievement of projected reductions in Medicare cost growth[4] reflected in the 2011 and 2010 Statements of Social Insurance, prevented us from expressing opinions on those statements,[5] as well as on the 2011 Statement of Changes in Social Insurance Amounts. Given the importance of social insurance programs, such as Medicare and Social Security to the federal government's long-term fiscal outlook, the Statement of Social Insurance is critical to understanding the federal government's financial condition and fiscal sustainability.

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the U.S. government's accrual-based consolidated financial statements. The underlying long-standing material weaknesses in internal control[6] contributed to our disclaimers of opinion on the U.S. government's accrual-based consolidated financial statements for the fiscal years ended 2011 and 2010.[7] Those material weaknesses relate to the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of

[4] These uncertainties are discussed in Note 26 to the consolidated financial statements.

[5] We expressed unqualified opinions on the 2009, 2008, and 2007 Statements of Social Insurance.

[6] A 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.

[7] A more detailed description of the material weaknesses that contributed to our disclaimer of opinion, including the primary effects of these material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 224 through 228 of the *Financial Report*.

Defense (DOD), were properly reported in the accrual-based consolidated financial statements;

- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the 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 U.S. generally accepted accounting principles (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 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 the Supplemental Information section of the *Financial Report*) 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.

In addition to the material weaknesses 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.[8] 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,[9]
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

Since the enactment of key financial management reforms in the 1990s, significant progress has been made improving financial management activities and practices. For fiscal year 2011, 21 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their accrual-based financial statements[10] within an accelerated reporting time frame, up from 6 CFO Act agencies for fiscal year 1996. Also, the preparation and audit of financial statements have identified numerous deficiencies, leading to actions to strengthen controls and systems. However, many of the CFO Act agencies continue to struggle with financial systems that are not integrated and do not meet the needs of management for reliable, useful, and timely financial information. Often, federal entities expend major time, effort, and resources to develop financial information that their systems should be able to provide on a daily or recurring basis. Therefore, it is important for the individual federal entities to remain committed to maintain the progress that has been achieved in obtaining positive audit results and to build upon that progress to make needed improvements.

[8] A more detailed discussion of these weaknesses, including the primary effects of the material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 229 and 230 of the *Financial Report*.

[9] Federal entities reported estimates of improper payment amounts that totaled $115.3 billion for fiscal year 2011, which represented approximately 4.7 percent of about $2.5 trillion of reported outlays for the associated programs.

[10] See app. I for the fiscal year 2011 audit results for the 24 CFO Act Agencies.

Addressing Impediments to an Opinion on the Accrual-Based Consolidated Financial Statements

Three long-standing major impediments continued to prevent us from expressing an opinion on the U.S. government's accrual-based consolidated financial statements: (1) serious financial management problems at 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, while improvements were made, financial management issues at the Department of Homeland Security (DHS) also contributed to our inability to express an opinion on the U.S. government's accrual-based consolidated financial statements. Extensive efforts by DOD and other entity officials and cooperative efforts between entity chief financial officers, Treasury officials, and Office of Management and Budget (OMB) officials will be needed to resolve these obstacles to achieving an opinion on the U.S. government's accrual-based consolidated financial statements.

Improving Financial Management at DOD

DOD leadership has, with oversight and reinforcement from Congress, committed DOD to the long-term goal of full financial statement auditability. The National Defense Authorization Act for Fiscal Year 2010, as amended, requires that DOD's financial statements be validated as ready for audit by September 30, 2017,[11] a date that has been DOD's stated goal since 2008. DOD's Financial Improvement and Audit Readiness (FIAR) Plan and semiannual status reports define the activities, corrective actions, and interim milestones necessary to achieve auditability and the availability of reliable, useful, and timely information for management decision making. The most recent update of the plan also emphasizes the importance of leadership, including senior leaders and field commanders, to achieving DOD's goals, and it links accountability to performance appraisals.

Under its FIAR Plan, DOD is focusing on improving controls and processes relied on to provide financial information in two areas it says are most critical to managing its operations: (1) budgetary information and (2) accountability over its military equipment. With respect to budgetary information, in October 2011, the Secretary of Defense directed the DOD

[11] National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84, § 1003(a), (b), 123 Stat. 2190, 2439-40 (Oct. 28, 2009).

Comptroller to provide him with a plan to achieve audit readiness for the Statement of Budgetary Resources (SBR) by the end of 2014. The SBR is important because it is intended to show the flow of money in and out of DOD consistent with the budgetary information reported in the *Budget of the United States Government*.[12] The Secretary's directive also called for increased emphasis on accountability for assets, a full review of DOD's financial controls over the next 2 years and the establishment of interim goals, mandatory training for audit and key financial efforts, and establishing a pilot certification program for financial managers by the end of calendar year 2012.

DOD recently updated its FIAR Guidance, which provides a standardized methodology for DOD components to follow in planning and carrying out their FIAR efforts aimed at achieving audit readiness. However, as we reported in September 2011, we found that the Air Force and the Navy were not always effectively implementing the FIAR Guidance, presenting a risk of not achieving DOD's overall FIAR goals.[13] Specifically, we found that although the Air Force asserted audit readiness for its military equipment and the Navy asserted audit readiness for its civilian pay, neither of these areas were audit-ready because the Air Force and Navy had not fully carried out FIAR Guidance procedures. We recommended actions for improving the development, implementation, documentation, and oversight of DOD's financial management improvement efforts. In addition, the Marine Corps' attempt to achieve an audit opinion on its SBR is still in process. In that regard, we recently recommended that the Marine Corps develop a risk-based remediation plan and confirm that its actions fully respond to auditor recommendations and that DOD direct other military services to consider key lessons learned in their audit readiness plans as appropriate.

The Navy and Marine Corps also continue to address a key element necessary to achieve an auditable SBR—the reconciliation of their balance of funds with the balance on Treasury's books, or Fund Balance with Treasury (FBWT). (The process is similar in concept to reconciling a

[12] According to DOD officials, the goal of achieving SBR audit readiness by 2014 will only apply to the department's general funds, but not to its working capital funds.

[13] GAO, *DOD Financial Management: Improvement Needed in DOD Components' Implementation of Audit Readiness Effort*, GAO-11-851 (Washington, D.C.: Sept. 13, 2011).

checkbook with a bank account.) Because of the fundamental importance of the reconciliation, GAO reviewed the processes used by the Navy, Marine Corps, and the Defense Finance and Accounting Service, which processes much of DOD components' financial data, including transactions that affect FBWT.[14] We recommended that the Navy and Marine Corps improve policies and procedures that guide the FBWT reconciliation process, provide training to communicate these policies and procedures to staff, and resolve system deficiencies.

The effective implementation of Enterprise Resource Planning (ERP) systems will be critical to the success of all of DOD's planned long-term financial improvement efforts. ERP systems are integrated, multifunction systems that perform business-related tasks such as general ledger accounting and supply chain management. DOD considers their implementation essential to transforming its business operations. However, DOD continues to encounter difficulties in implementing its planned ERP systems on schedule and within budget. For example, in October 2010, we reported that six of nine critical DOD ERPs experienced schedule delays ranging from 2 to 12 years.[15] We also reported that five of these ERPs incurred cost increases totaling an estimated $6.9 billion. We made eight recommendations to DOD aimed at improving schedule and cost practices and the development of performance measures to evaluate whether the ERPs' intended goals are being accomplished.

Another key to effectively transforming DOD's financial management will be its ability to ensure that it has sufficient staff with the appropriate skills necessary to carry out financial and budgetary accounting duties. To that end, DOD is establishing a Financial Management Certification Program to be mandatory for its personnel in financial management positions. However, DOD has not yet performed a competency gap analysis for its financial management workforce as we reported in July 2011.[16] Further,

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[14] GAO, *DOD Financial Management: Ongoing Challenges with Reconciling Navy and Marine Corps Fund Balance with Treasury*, GAO-12-132 (Washington, D.C.: Dec. 20, 2011).

[15] GAO, *DOD Business Transformation: Improved Management Oversight of Business System Modernization Efforts Needed*, GAO-11-53 (Washington, D.C.: Oct. 7, 2010).

[16] GAO, *DOD Financial Management: Numerous Challenges Must Be Addressed to Improve Reliability of Financial Information*, GAO-11-835T (Washington, D.C.: July 27, 2011).

the House Armed Services Committee (HASC) Panel on Defense Financial Management and Auditability Reform, which held several hearings on DOD financial management, recently reported that DOD personnel in other functional areas, such as logistics and acquisition, should also have the skills necessary to maintain appropriate controls and ensure that financial-related information is accurately recorded.[17] The HASC Panel made several recommendations about DOD's workforce, including recommending that DOD assess its financial management workforce with respect to existing skills and the critical skills and competencies that will be needed over the next decade.

While we are encouraged by DOD's recent plans and efforts to fundamentally transform its financial management operations, several DOD business practices, including financial management, remain on GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement or in need of transformation.[18] Given the size, complexity, and interrelated nature of DOD's financial management and other business process control deficiencies, the sustained commitment by DOD's leaders will be critical to effectively building on DOD's initial momentum to transform its financial management operations and ultimately achieve auditability. Further, we agree with the recommendation by the HASC Panel on Defense Financial Management and Auditability Reform that strong congressional oversight must continue.[19] To assist Congress in its oversight efforts, we plan to reassess the FIAR Plan, associated guidance, and DOD's related actions as they continue to evolve.

Reconciling Intragovernmental Activity and Balances

Since the first audit of the U.S. government's fiscal year 1997 consolidated financial statements, we have reported a material weakness related to the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, as well as between federal entities and the General Fund. Consolidated financial statements are intended to present the results of operations and financial position of the components that make up the

[17] House Armed Services Committee, *Panel on Defense Financial Management and Auditability Reform Findings and Recommendations* (Jan. 24, 2012).

[18] GAO, *High-Risk Series: An Update*, GAO-11-278 (Washington, D.C.: February 2011).

[19] House Armed Services Committee, *Panel on Defense Financial Management and Auditability Reform Findings and Recommendations* (Jan. 24, 2012).

reporting entity as if the entity were a single enterprise. Therefore, when preparing the consolidated financial statements, intragovernmental activity and balances between federal entities and between federal entities and the General Fund should be in agreement and must be subtracted out, or eliminated, from the financial statements. If the two federal entities engaged in an intragovernmental transaction do not both record the same intragovernmental transaction in the same year and for the same amount, the intragovernmental transactions will not be in agreement, resulting in errors in the consolidated financial statements.

Treasury has grouped intragovernmental activity and balances into the following five categories and established focus groups to work with federal entity personnel to identify and resolve reported unreconciled differences.

- **Fiduciary activities** include investments in Treasury securities with the Bureau of the Public Debt (BPD), borrowing from BPD and the Federal Financing Bank and related interest receivable and payable, interest expense and revenue, and federal loans receivable and payable.
- **Benefit activities** include contributions by federal entities into employee benefit programs (retirement, life insurance, workers' compensation, and health benefits) administered by the Office of Personnel Management and the Department of Labor.
- **Buy/Sell activities between entities** include buy and sell costs and revenues, accounts receivable and payable, and advances to and from others.
- **Transfers of funds** include transfers payable and receivable, and transfers in and out without reimbursement.
- **General Fund transactions and balances** include fund balance with Treasury, appropriations received and warrants, and custodial and non-entity collections.

The federal government has made progress in reconciling intragovernmental differences and the degree of progress varies by category. However, the federal government continues to be unable to adequately account for and reconcile intragovernmental activity and balances. For both fiscal years 2011 and 2010, amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. OMB and Treasury require the CFOs of 35 significant federal entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. A substantial number of the entities did not adequately perform the required year-end reconciliations for fiscal years 2011 and 2010.

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. Currently, federal entities report their activity with the General Fund; however, the General Fund activity is not centrally accounted for, and therefore, there is no existing reporting process for which entities can confirm and reconcile all of their activity and balances with the General Fund. As a result of these circumstances, the federal government's ability to determine the impact of the unreconciled differences between trading partners on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

Over the years, we have identified and reported on numerous intragovernmental activities and balances issues and have made several related recommendations to Treasury. Treasury has taken or plans to take actions to address these recommendations. 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.[20] 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 governmentwide 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 that will be audited. 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 Treasury and OMB.

Preparing the 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

[20] Beginning 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.

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 GAAP.[21] For example,

- Treasury's process did not ensure that the information in certain of the accrual-based consolidated financial statements was fully consistent with the underlying information in 35 significant federal entities' audited financial statements and other financial data.
- 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 Statement of Operations and Changes in Net Position, which it labeled "Unmatched transactions and balances."[22] 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.
- Treasury's reporting of certain financial information required by GAAP continues to be impaired, and will remain so until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

Until these and other internal control deficiencies[23] 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

[21] Most 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).

[22] Although 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 consolidated financial statements.

[23] A detailed discussion of additional control deficiencies regarding the process for preparing the consolidated financial statements can be found on pages 226 through 228 of the *Financial Report*.

strong and sustained commitment from Treasury and OMB as they continue to execute and implement their corrective action plans.

Improving Financial Management at DHS

Improvements in DHS's financial management during fiscal year 2011 contributed to DHS receiving a qualified opinion on its Balance Sheet and Statement of Custodial Activity for the fiscal year.[24] These statements were qualified because of certain matters related to property, plant, and equipment; environmental liabilities; and other related balances. This qualified opinion represents a significant achievement for DHS. However, the remainder of its financial statements for fiscal year 2011 were not subjected to audit by the agency auditors, and 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 will be important that DHS continues to resolve its internal control deficiencies and build upon the progress it has accomplished as it moves forward to expand the audit to all 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.

Significant Uncertainties Result in Disclaimers of Opinion on the 2011 and 2010 Statements of Social Insurance as well as on the 2011 Statement of Changes in Social Insurance Amounts

Significant uncertainties, 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 opinions on the 2011 and 2010 Statements of Social Insurance, as well as on the 2011 Statement of Changes in Social Insurance Amounts.[25] 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

[24] For fiscal year 2010, these two statements were not auditable.

[25] About $24.6 trillion and $22.8 trillion, or 73 percent and 74 percent, of the federal government's reported total present value of future expenditures in excess of future revenue for 2011 and 2010, respectively, relate to the Department of Health and Human Services' 2011 and 2010 Statements of Social Insurance, which received disclaimers of opinion.

using a projection period sufficient to illustrate the long-term sustainability of the social insurance programs.[26]

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),[27] 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.[28] 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

[26] The 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.

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

[28] The Medicare and Medicaid Extenders Act of 2010, Pub. L. No. 111-309, § 101, 124 Stat. 3285, 3286 (Dec. 15, 2010) overrode the scheduled reductions in physician payments through December 2011 and reduced non-Medicare outlays by limiting a health insurance tax credit. Subsequent to the date of our 2011 report, (1) the Temporary Payroll Tax Cut Continuation Act of 2011, Pub. L. No 112-78, § 301, 125 Stat. 1280, 1283-1284 (Dec. 23, 2011) overrode the scheduled reductions in physician payments through February 29, 2012 and (2) the Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96, § 3003 (Feb. 22, 2012) overrode the scheduled reductions in physician payments through December 31, 2012.

whether legislation would include other provisions to help offset such costs.[29]

- 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 rate used in the projections.[30] 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. In 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. The work of the 2010 Technical Review Panel on the Medicare Trustees Report could provide additional guidance to management concerning ways to incorporate secondary impacts into future Statement of Social Insurance projections and related disclosures.

As noted in our audit report, in preparing the Statements of Social Insurance, management considers and selects assumptions and data that

[29] Public law 112-96 offset the physician payment reductions through various cuts under certain health care laws (public laws 111-148 and 111-152), as well as to Medicare payments to hospitals, skilled nursing facilities and clinical labs.

[30] The excess cost growth rate is the increase in health care spending per person relative to the growth of gross domestic product per person after removing the effects of demographic changes on health care spending.

it believes provide a reasonable basis for the assertions in the statement. The statement is not a forecast or prediction, but is intended to illustrate the potential impact of the continuation of current scheduled benefits and financing. The *Financial Report* includes a summary of the assumptions used by management and unaudited information concerning how changes in various key assumptions, such as health care cost growth, would affect the Statement of Social Insurance. Both the Statement of Social Insurance projections and the illustrative alternative estimate summarized in Note 26 in the *Financial Report* indicate that the Social Security and Medicare programs are not sustainable under current financing arrangements.

Effects of the Last Economic Recession and Stabilization Efforts on the Federal Government's Financial Condition

The federal government's financial condition continued to be significantly affected by the last economic recession and the federal government's actions to stabilize financial markets and promote economic recovery, among other factors. For fiscal year 2011, the federal government reported a net operating cost of about $1.3 trillion and a unified budget deficit of approximately $1.3 trillion. In addition, federal debt held by the public increased to about 68 percent of gross domestic product (GDP) as of September 30, 2011.[31]

The federal government undertook an array of unprecedented actions to help stabilize the financial markets and promote economic recovery. As of September 30, 2011, the federal government reported assets of over $295 billion, which is net of about $95 billion in valuation losses, as a result of these actions. In addition, the federal government reported incurring significant liabilities resulting from these actions as of September 30, 2011, including approximately $316 billion of liabilities for future payments to the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently subject to substantial

[31] Federal debt held by the public relative to GDP is a function of the federal government's fiscal policy as well as overall economic conditions. The Congress and the President have enacted laws to establish a limit on the amount of federal debt that can be outstanding at one time. Federal debt subject to the limit includes both debt held by the public and debt held by government accounts (intragovernmental debt holdings). In February 2011, we reported on the debt limit in GAO, *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, GAO-11-203 (Washington, D.C.: Feb. 22, 2011).

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.

Actions taken to stabilize financial markets—including aid to the automotive industry—increased the government's costs and contributed to growing federal debt held by the public. The economic downturn and the nature and magnitude of the actions taken to stabilize the financial markets and to promote economic recovery, as well as challenges in the housing market, will continue to affect the federal government's near-term budget and debt outlook. In addition, the future structure of Fannie Mae and Freddie Mac and the roles they will serve in the mortgage markets may also affect the federal government's financial condition.

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.

Long-Term Fiscal Challenges

The 2011 *Financial Report* includes comprehensive long-term fiscal projections for the U.S. government that, consistent with GAO simulations, show that without changes in current policy, the federal government continues to face an unsustainable fiscal path.[32] Such reporting provides a much needed perspective on the federal government's long-term fiscal position and outlook. The projections included in the *Financial Report* and our simulations both reflect an improvement resulting from provisions of the Budget Control Act of 2011 (BCA).[33] The BCA set limits on discretionary spending for fiscal years 2012-2021 and created the Joint Select Committee on Deficit Reduction. Under the enacted discretionary spending limits, discretionary spending as a share of the economy in 2021 would be lower than any level seen in

[32] GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2011 Update,* GAO-12-28SP (Washington, D.C.: Oct. 23, 2011).

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

the last 50 years. The fact that the Joint Select Committee did not reach agreement on a package triggered automatic procedures that would lead to additional spending reductions. Together, the provisions of the BCA would reduce deficits over the 2012-2021 decade by $2.1 trillion—largely through reductions in discretionary spending. Both the *Financial Report* and GAO's simulations assume these reductions occur, and that the savings as a share of GDP continue beyond the decade. Even with the reductions from the BCA, the government continues to face a significant structural imbalance between revenues and spending, driven on the spending side largely by rising health care costs and the aging of the U.S. population. We have already begun to see the impact of this structural imbalance—Social Security is now in a negative cash flow position. The growing gap between revenues and spending that is built into the current structure of the budget leads to continued growth in debt held by the public as a share of GDP; this is not sustainable. Changing this path will not be easy, and it will likely require difficult decisions affecting both federal spending and revenue. While delay increases the size of the changes that must be made, it is also important to recognize current economic conditions. Addressing the long-term fiscal imbalance is made more difficult by the need to balance achieving the goals of sustaining economic growth in the near term, while producing a plan to change the federal government's long-term fiscal path.

Closing Comments

In closing, even though progress has been made in improving federal financial management activities and practices, much work remains given the federal government's long-term fiscal challenges and the need for the Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information to effectively meet these challenges. Sound decisions on the current and future direction of vital federal government programs and policies are more difficult without reliable, useful, and timely financial and performance information. DOD, in particular, faces many difficult challenges in this area. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses and its efforts to achieve auditability. However, sustained and diligent DOD top management oversight toward achieving financial management capabilities, including audit readiness, will be critical going forward. Moreover, in addition to annual financial statements that can pass the scrutiny of a financial audit, the civilian CFO Act agencies must continue to strive toward routinely producing reliable, useful, and timely financial and performance data to help guide decision makers on a day-to-day basis. Federal entities' improvement of financial management systems will be essential to achieve this goal for their agency and the government as a whole.

The last economic recession and the federal government's actions to stabilize financial markets continued to significantly affect the federal government's financial condition. Continued focus and attention is needed to ensure (1) that sufficient internal controls and transparency are established and maintained for all financial stabilization efforts; and (2) that all related financial transactions are reported on time, accurately, and completely. In addition, 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.

Further, of utmost concern are the federal government's long-term fiscal challenges that result from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. This unsustainable path must be addressed by policymakers.

Finally, I want to emphasize the value of sustained congressional interest in federal financial management issues, as demonstrated by this Subcommittee's leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees continue to support improvement efforts and to hold the top leadership of federal entities accountable for resolving the remaining problems.

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

GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact Robert F. Dacey, Chief Accountant, or Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-3406. Key contributions to this testimony were also made by staff on our Consolidated Financial Statement audit team.

Appendix I: Chief Financial Officers (CFO) Act Agencies: Fiscal Year 2011 Audit Results and Principal Auditors

CFO Act agencies	Opinion expressed by agency auditor	Agency auditor-reported material weaknesses or noncompliance[a]	Principal auditor
Agency for International Development	Unqualified	√	Office of Inspector General (OIG)
Agriculture	Unqualified	√	OIG
Commerce	Unqualified		KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified		KPMG LLP
Health and Human Services	[b]	√	Ernst & Young LLP
Homeland Security	[c]	√	KPMG LLP
Housing and Urban Development	Unqualified	√	OIG
Interior	Unqualified	√	KPMG LLP
Justice	Unqualified		KPMG LLP
Labor	Unqualified	√	KPMG LLP
National Aeronautics and Space Administration	Unqualified		PricewaterhouseCoopers LLP
National Science Foundation	Unqualified		Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified		Clifton Gunderson LLP
Office of Personnel Management	Unqualified	√	KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		Grant Thornton LLP
State	[d]	√	Kearney & Company
Transportation	Unqualified	√	Clifton Gunderson LLP
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Clifton Gunderson LLP

Source: GAO.

[a]Reported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

[b]The auditors expressed an unqualified opinion on the Department of Health and Human Services' fiscal year 2011 accrual-based financial statements, but were unable to express opinions on the department's 2011 Statement of Social Insurance and 2011 Statement of Changes in Social Insurance Amounts.

[c]For fiscal year 2011, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit. The auditors expressed a qualified opinion on these two financial statements.

[d]The auditors of the Department of State's fiscal year 2011 financial statements issued a qualified opinion because of the effect of certain matters related to after-employment actuarial liabilities and benefit plan assets and net position balances.

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