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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, 2010 and 2009, and the 2010, 2009, 2008, 2007, and 2006 Statements of Social Insurance, 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 Statement of Social Insurance.[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

[1] The 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.

[2] The accrual-based consolidated financial statements for the fiscal years ended September 30, 2010 and 2009 consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. The 2010, 2009, 2008, 2007, and 2006 Statements of Social Insurance, including the related notes, are also included in the consolidated financial statements. The Statements of Social Insurance do not interrelate to the accrual-based consolidated financial statements.

[3] 31 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.

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.

In summary, we found the following:

- Certain material weaknesses[5] in internal control over financial reporting and other limitations on the scope of our work[6] 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, 2010 and 2009.[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 2010 Statement of Social Insurance, prevented us from expressing an opinion on that statement. The Statements of Social Insurance for 2009, 2008, and 2007[8] are presented fairly, in all material respects, in conformity with GAAP; and we disclaim an opinion on the 2006 Statement of Social Insurance.

- Material weaknesses resulted in ineffective internal control over financial reporting (including safeguarding of assets).

- Our work to test compliance with selected provisions of laws and regulations in fiscal year 2010 was limited by the material weaknesses and other scope limitations discussed in this report.

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[4] 31 U.S.C. 3512 note (Federal Financial Management Improvement Act).

[5] 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.

[6] Three 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 financial statements of the Department of Homeland Security for fiscal years 2010 and 2009 and the Department of Labor for fiscal year 2010 were not auditable or not subjected to audit by agency auditors. Further, some of the financial statements of the National Aeronautics and Space Administration for fiscal year 2010 were not fully auditable and for fiscal year 2009 all were not auditable.

[7] We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2006 and on the accrual-based consolidated financial statements of the U.S. government for fiscal years 2007 through 2009.

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

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 *2010 Financial Report of the United States Government* (*2010 Financial Report*) into context.

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

The accrual-based consolidated financial statements for fiscal year 2010 include, as they did for fiscal year 2009, substantial assets and liabilities resulting from the federal government's actions to stabilize financial markets and to promote economic recovery. Although the federal government has received positive returns from investments in certain large financial institutions, it continues to report significant costs related to these actions. 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 *2010 Financial Report* and certain 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, 2010, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in assets of over $400 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 $75 billion in valuation losses. In addition, the federal government reported incurring significant liabilities as of September 30, 2010 (e.g., about $360 billion related to estimated future payments to Fannie Mae and Freddie Mac) and related net cost 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

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[9]TARP 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 Web Site at www.gao.gov.

[10]The 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.

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, 2010, 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

While the economy is still fragile and in need of careful attention, there is wide agreement on the need to look not only at the near-term but also at steps that begin to change the long-term fiscal path as soon as possible without slowing the economy. As discussed in the *2010 Financial Report*, the federal government is on an unsustainable long-term fiscal path driven on the spending side primarily by rising health care costs and known demographic trends. Under new financial reporting standards, this *2010 Financial Report* includes comprehensive long-term fiscal projections for the U.S. government, expanding on similar information presented in recent years' financial reports. The projections show that the present value of projected non-interest spending exceeds receipts by about $16.3 trillion over the next 75-year period.[11] The projections relating to Social Security and Medicare are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume reductions in Medicare cost growth. GAO also prepares long-term simulations for all federal government programs. Under GAO's Alternative simulation,[12] absent policy change, by 2020 roughly 92 cents of every dollar of federal revenue would be spent on net interest costs, Social Security, Medicare, and Medicaid; and debt held by the public as a share of gross domestic product (GDP) would by 2020 exceed the historical high reached in the aftermath of World War II.[13] The federal government faces increasing pressures, yet a shrinking window of opportunity, for making policy changes regarding these challenges.

In February 2010, the President established the bipartisan National Commission on Fiscal Responsibility and Reform to identify policies to change this fiscal path and stabilize the debt-to-GDP ratio. The Commission's report was issued on December 1, 2010.[14] Other policy groups have also developed proposals to deal with the federal government's long-term fiscal challenge.

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[11]On an open group basis (current and future participants).

[12]GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2010 Update*, GAO-11-201SP (Washington, D.C.: November 2010).

[13]GAO's Alternative simulation incorporates Congressional Budget Office and Centers for Medicare & Medicaid Services alternative projections for health care cost growth, which assume certain cost controls are not maintained over the long term and physician payments are not reduced as specified under current law. Also in this simulation, all tax provisions are extended to 2020 and the alternative minimum tax (AMT) exemption amount is indexed to inflation through 2020; revenues are then brought back to the 40-year historical average as a share of GDP; and discretionary spending grows with GDP during the entire period—keeping it just below the 40-year historical average as a share of GDP.

[14]*The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, National Commission on Fiscal Responsibility and Reform (Washington, D.C.: Dec. 1, 2010).

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 entities meet the criteria for a federal entity. The investments in and any liabilities to such entities, however, are valued and reported on the Balance Sheet.

DISCLAIMER 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 2010 and 2009, 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;

- 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.

DISCLAIMER OF OPINION ON THE STATEMENT OF SOCIAL INSURANCE FOR 2010 AND UNQUALIFIED OPINIONS FOR 2009, 2008, AND 2007

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 2010 Statement of Social Insurance, we were unable to obtain sufficient evidence to support the amounts presented in the 2010 Statement of Social Insurance. Consequently, we are unable to, and we do not, express an opinion on the 2010 Statement of Social Insurance. 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.[15]

[15]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 2040.

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

- Medicare projections in the 2010 Statement of Social Insurance were based on full implementation of the provisions of the Patient Protection and Affordable Care Act (PPACA),[16] including a significant decrease in projected Medicare costs from the 2009 Statement of Social Insurance related to (1) reductions in physician payment rates totaling 30 percent over the next 3 years 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 2010 Statement of Social Insurance due to the likelihood of modifications to the scheduled reductions.[17] 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, exceed the $22.8 trillion estimate in the 2010 Statement of Social Insurance by $12.4 trillion.

As a result, readers are cautioned that amounts reported in the 2010 Statement of Social Insurance and related Notes 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 2010 Statement 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 *2010 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

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[16]Patient 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).

[17]As of the date of our report, legislation was awaiting the President's signature that would override the scheduled reductions in physician payments through December 31, 2011 and reduce non-Medicare outlays by limiting a health insurance tax credit. See H.R. 4994, 111th Cong. § 101 (2010).

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. We have not audited and do not express an opinion on the 2006 Statement of Social Insurance.

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 *2010 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 2037 and 2029, respectively, at which time they will be unable to pay the full amount of scheduled future benefits. For Social Security, projected future revenues as of January 1, 2010 would be sufficient to pay 78 percent of scheduled benefits in 2037, the year of trust fund exhaustion, and decreasing to 75 percent of scheduled benefits in 2084. Similarly, for Medicare Hospital Insurance (Part A), projected future revenues as of January 1, 2010 would be sufficient to pay 85 percent of scheduled benefits in 2029, the year of trust fund exhaustion, declining to 77 percent in 2050 and then increasing to 89 percent of scheduled benefits in 2084.

OTHER LIMITATIONS ON THE SCOPE OF OUR WORK

For fiscal years 2010 and 2009, 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 2010 and 2009 primarily because of insufficient representations provided to them by certain agencies. In addition, the federal government was unable to provide us with adequate legal representations regarding the U.S. government's accrual-based consolidated financial statements for fiscal year 2009.

OTHER MATTERS

In fiscal year 2010, the federal government adopted several new federal accounting standards, including those for (1) reporting pensions, other retirement benefits, and other post-employment benefits [Statement of Federal Financial Accounting Standards (SFFAS) No. 33], as discussed in Notes 1, 15, and 21 to the consolidated financial statements; and (2) reporting comprehensive long-term fiscal projections for the U.S. government [SFFAS No. 36], as discussed in Note 1 to the consolidated financial statements and Supplemental Information.

Also, as discussed in Notes 1 and 24 to the consolidated financial statements, the fiscal year 2009 Statements of Changes in Cash Balance from Unified Budget and Other Activities and the fiscal year 2009 Statement of Operations and Changes in Net Position were restated to correct certain balances. In addition, certain information in Note 23 to the consolidated financial statements was restated. Last year, we disclaimed an opinion on the fiscal year 2009 accrual-based consolidated financial statements due to certain material weaknesses and limitations on the scope of our work, including the material weakness related to the preparation of the consolidated financial statements. Given the material weaknesses and scope limitations discussed in this report, additional restatements may occur in the future.

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.[18]

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, which were discussed above, 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.

[18]A 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 internal control that involve the following areas:

- implementing effective internal controls at certain federal entities for loans receivable and loan guarantee liabilities, which for the most part, involve credit subsidy estimation and related financial reporting processes; and

- preparing the Statement of Social Insurance for certain programs.

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 *2010 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. However, we compared the information that directly related to the Statements of Social Insurance for consistency with the 2009, 2008, and 2007 Statements of Social Insurance and discussed the methods of measurement and presentation of such information with Treasury officials. Based on this limited work, we found no material inconsistencies with such Statements of Social Insurance or GAAP.

Readers are cautioned that the material weaknesses and scope limitations discussed in this audit report, including those related to our disclaimer of opinion on the 2010 Statement of Social Insurance, 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 and the 2010 Statement of Social Insurance.

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 systems[19] 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 2010 and 2009, auditors for 10 of the 24 CFO Act agencies 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. Agency management at 7 CFO Act agencies reported that their agencies' systems were not in substantial compliance with one or more of the three FFMIA requirements for fiscal years 2010 and 2009. 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 agency's 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

[19]The 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.

management challenge in providing accountability to the nation's taxpayers and have contributed significantly to our inability to determine the reliability of the accrual-based consolidated financial statements.

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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

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

December 13, 2010

APPENDIX I

Objective, Scope, and Methodology

Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2010 and 2009 (as well as 2008, 2007, and 2006 with respect to the Statements of Social Insurance), including 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 agencies[20] 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 2002[21] 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 entities[22] 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 2009.[23] We also separately audited the financial statements of the following significant federal entities and federal agency components:

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2010 and 2009 financial statements.[24] In fiscal years 2010 and 2009, IRS collected about $2.3 trillion each year in tax payments and paid about $467 billion and $438 billion, respectively, in refunds to taxpayers. For fiscal year 2010, we continued to report material weaknesses that resulted in ineffective internal control over financial reporting. In addition, we found a significant deficiency in

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[20]31 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).
[21]Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002); *see* 31 U.S.C. 3515.
[22]See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 entities.
[23]For our report on the U.S. government's consolidated financial statements for fiscal year 2009, see U.S. Department of the Treasury, *Fiscal Year 2009 Financial Report of the United States Government* (Washington, D.C.: Feb. 2010), pp. 209-234, which can be found on GAO's Web site at www.gao.gov/financial.html.
[24]GAO, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements*, GAO-11-142 (Washington, D.C.: Nov. 10, 2010).

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 2010 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 the Federal Financial Management Improvement Act of 1996.

- 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, 2010 and 2009.[25] For these 2 fiscal years, the schedules reported (1) approximately $9.0 trillion (2010) and $7.6 trillion (2009) of federal debt held by the public;[26] (2) about $4.5 trillion (2010) and $4.3 trillion (2009) of intragovernmental debt holdings;[27] and (3) about $215 billion (2010) and $189 billion (2009) of interest on federal debt held by the public. We reported that as of September 30, 2010, BPD had effective internal control over financial reporting relevant to the Schedule of Federal Debt. Further, we reported that there was no reportable BPD noncompliance in fiscal year 2010 with a significant provision of law related to the Schedule of Federal Debt (statutory debt limit) we tested.

- We audited and expressed unqualified opinions on the fiscal years 2010 and 2009 financial statements of the United States Securities and Exchange Commission (SEC).[28] We also reported that as of September 30, 2010, SEC did not have effective internal control over financial reporting due to two material weaknesses in internal control. In addition, we reported that there was no reportable noncompliance in fiscal year 2010 with the selected provisions of laws and regulations we tested.

- We audited and expressed an unqualified opinion on the fiscal years 2010 and 2009 financial statements of the Federal Housing Finance Agency (FHFA).[29] We reported that FHFA had effective internal control over financial reporting, and we found no reportable noncompliance in fiscal year 2010 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 2010 and 2009 financial statements for the Troubled

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[25]GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2010 and 2009 Schedules of Federal Debt*, GAO-11-52 (Washington, D.C.: Nov. 8, 2010).

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

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

[28]GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2010 and 2009*, GAO-11-202 (Washington, D.C.: Nov. 15, 2010).

[29]GAO, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2010 and 2009 Financial Statements*, GAO-11-151 (Washington, D.C.: Nov. 15, 2010).

Asset Relief Program (TARP).[30] We reported that although certain internal controls could be improved, OFS had effective internal control over financial reporting as of September 30, 2010. We also reported that we found no reportable noncompliance for the period ended September 30, 2010, with the selected provisions of laws and regulations we tested.

- We audited and expressed unqualified opinions on the December 31, 2009 and 2008, 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 (FSLIC) Resolution Fund.[31] We reported that as of December 31, 2009, FDIC's internal control over financial reporting was not effective because of a material weakness in internal control related to its process for estimating losses on loss-sharing agreements, and we found no reportable noncompliance for calendar year 2009 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 2010 and 2009 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 included in the *DOD Agency Financial Report for 2010* that certain major deficiencies related to noncompliant systems and noncompliant processes continued to impact the department's ability to prepare reliable financial statements. In addition, DOD refers to its ongoing efforts to address related material weaknesses reported by the DOD Inspector General. In the DOD Inspector General's fiscal year 2010 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 related to the Social Security Administration (SSA) and the Department of Health and Human Services (HHS), our audit approach regarding the Statement of Social Insurance focused primarily on these two agencies. For each federal entity preparing a Statement of

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[30] GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Years 2010 and 2009 Financial Statements*, GAO-11-174 (Washington, D.C.: Nov. 15, 2010).
[31] GAO, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2009 and 2008 Financial Statements*, GAO-10-705 (Washington, D.C.: June 25, 2010).

Social Insurance,[32] we considered the entity's fiscal year 2010, 2009, 2008, 2007, and 2006 financial statements and 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 and the 2010 and 2006 Statements of Social Insurance in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

[32]These 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. Other 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, if 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 affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably 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 2010 and 2009, there was unreconciled disbursement activity, including unreconciled differences between federal entities' and the Department of 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

Federal entities are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 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 reconciliations for fiscal years 2010 and 2009. 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. Agencies are required to complete their *Material Differences Reports*, which includes providing explanations of the reasons for the differences. Based on our analysis of the completed *Material Differences Reports* for fiscal year 2010, we noted that a significant number of CFOs were unable to adequately explain the reasons for the differences with their trading partners or did not provide adequate documentation to support responses in their entities' *Material Differences Reports*. For both fiscal years 2010 and 2009, amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication as to when the differences would be resolved. 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.

Treasury continues to take steps to help resolve material differences in intragovernmental activity and balances. For example, beginning with the third quarter of fiscal year 2010 intragovernmental reporting, CFOs were required to certify the explanations included in their entities' completed *Material Differences Report*. Further, during fiscal year 2010, Treasury established additional focus groups, consisting of Treasury and agency personnel, to begin identifying and resolving certain reported material differences. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal entities to fully implement guidance regarding business rules for intragovernmental transactions issued by OMB and Treasury as well as continued strong leadership by OMB and Treasury.[33]

<u>Preparation of Consolidated Financial Statements</u>

While further progress was demonstrated in fiscal year 2010, 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

[33]On November 8, 2010, Treasury issued the Treasury Financial Manual (TFM) Bulletin No. 2011-04, *Intragovernmental Business Rules*, which rescinded and supersedes TFM Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance is effective for fiscal year 2011 and has updated the previous guidance to include, among other things, a new *Intragovernmental Dispute Resolution Request Form* to be certified by federal entity CFOs and disputes to be resolved by Treasury's Deputy Assistant Secretary—Accounting Policy, Office of the Fiscal Assistant Secretary.

accounting principles (GAAP). During our fiscal year 2010 audit, we found the following:[34]

- Treasury's process for compiling the consolidated financial statements generally demonstrated that amounts in the Statement of Social Insurance 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 2010, auditors for many of the CFO Act agencies continued to report control deficiencies regarding entities' financial reporting processes which, in turn, could affect the preparation of the consolidated financial statements. For example, auditors for several entities reported that a significant number of adjustments were required to prepare the entities' financial statements. Auditors are also required to separately audit financial information sent by the 35 significant federal entities to Treasury through a closing package. In connection with preparing the consolidated financial statements, several auditors reported significant deficiencies regarding the preparation of the closing package. Further, Treasury had to record significant adjustments to correct errors found in federal entities' audited closing package information.

- To make the fiscal years 2010 and 2009 consolidated financial statements balance, Treasury recorded net increases of $0.8 billion and $17.4 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Unmatched transactions and balances."[35] Treasury recorded an additional net $3.8 billion and $8 billion of unmatched transactions in the Statement of Net Cost for fiscal years 2010 and 2009, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

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[34]Most of the issues we identified in fiscal year 2010 existed in fiscal year 2009, and many have existed for a number of years. Most recently, in July 2010, 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-10-757 (Washington, D.C.: Jul. 30, 2010).

[35]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 accompanying consolidated financial statements.

- 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. As previously discussed, amounts reported for federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, there are 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.

- The federal government could not demonstrate that it had fully identified and reported all items needed to reconcile the operating results, which for fiscal year 2010 showed a net operating cost of $2.1 trillion, to the budget results, which for the same period showed a unified budget deficit of $1.3 trillion.

- 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 material weaknesses 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 monitoring to determine whether controls for preparing the consolidated financial statements were operating effectively. As a result, we identified numerous errors in draft consolidated financial statements that were subsequently corrected by Treasury.

- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2010 financial reporting challenges it faced, such as control deficiencies in Treasury's 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 amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. 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.

During fiscal year 2010, Treasury, in coordination with OMB, continued implementing corrective action plans and made progress in addressing certain internal control deficiencies we have previously reported. Until the 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 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 2010 and 2009 of $1.3 trillion and $1.4 trillion, respectively.[36] 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 material unreconciled differences between the total net outlays reported in selected federal entities' Statements of Budgetary Resources

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

(SBR) and Treasury's central accounting records used to compute the budget deficit[37] reported in the consolidated financial statements. Unreconciled net outlays of $40 billion and $28 billion existed for fiscal years 2010 and 2009, 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 consolidated financial statements will continue to be unknown.

In fiscal year 2010, 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,*[38] and in other federal government publications.

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[37]See 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).

[38]Treasury's *Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on 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

The federal government continues to make progress under the requirements of the Improper Payments Information Act of 2002 (IPIA)[39] in reporting on the nature and extent of improper payments.[40] Federal entities reported estimates of improper payment amounts that totaled $125.4 billion in fiscal year 2010, which represented about 5.5 percent of $2.3 trillion of reported outlays for the related programs. The $125.4 billion estimate is an increase of $16.2 billion from the prior year estimate of $109.2 billion.[41] Increases in reported estimates of improper payments were mostly attributable to four major programs: (1) Department of Labor's Unemployment Insurance program, (2) Department of the Treasury's Earned Income Tax Credit Program, (3) Department of Health and Human Services' (HHS) Medicaid program, and (4) HHS' Medicare Advantage program. The increases in the estimates for these programs primarily related to an increase in reported program outlays and, for the Unemployment Insurance and Earned Income Tax Credit programs, increases in reported error rates. Reported error rates declined in certain significant programs, including the Medicaid and Medicare Advantage programs, as well as the Department of Transportation's Federal Aid Highway program and Social Security Administration's Supplemental Security Income program. It is important to note that reported improper payment estimates include overpayments, underpayments, and payments for which adequate documentation was not

[39]Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002), as amended by the Improper Payments Elimination And Recovery Act of 2010, Pub. L. No. 111-204, 124 Stat. 2224 (July 22, 2010). The IPIA requires federal executive branch entities to review all programs and activities, identify those that may be susceptible to significant improper payments, estimate and report the annual amount of improper payments for those programs, and implement actions to reduce improper payments.

[40]IPIA defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts.

[41]In their fiscal year 2010 Performance and Accountability Reports (PAR) and Annual Financial Reports (AFR), select federal entities updated their fiscal year 2009 improper payment estimates to reflect changes since issuance of their fiscal year 2009 PARs and AFRs. These updates increased the governmentwide improper payment estimate for fiscal year 2009 from $98.7 billion to $109.2 billion.

found, and they may include amounts of payments for years prior to the current fiscal year.

While progress has been made in meeting the requirements of IPIA, the federal government still faces challenges in determining the full extent to which improper payments occur and to reasonably assure that appropriate actions are taken to reduce improper payments. For example, three federal entities did not report estimated improper payment amounts for fiscal year 2010 for 7 risk-susceptible programs that had aggregate outlays of at least $85 billion. Of these 7 programs, 6 risk-susceptible programs had reported improper payment estimated amounts in fiscal year 2008, but not in fiscal year 2009. Some entities cited insufficient documentation, incorrect computations, and changes in program requirements as causes of improper payments. Entity auditors also reported a variety of control deficiencies and challenges, such as financial systems limitations and contract monitoring issues that could allow improper payments to occur. Corrective actions needed to reduce improper payments may be unique to specific entities and programs. Furthermore, 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.

On November 20, 2009, the President issued Executive Order 13520, *Reducing Improper Payments*, which further heightened awareness of the need to reduce improper payments and eliminate waste, fraud, and abuse in federal programs. The order focuses on transparency, holding entities accountable, and creating incentives to reduce improper payments. The President also issued a March 10, 2010 memorandum on *Finding and Recapturing Improper Payments* that expands the use of payment recapture audits (recovery audit) for detecting and recapturing payment errors; and a June 18, 2010 memorandum directing that a "Do Not Pay List" be established to prevent improper payments from being made to ineligible recipients. Moreover, Congress passed the Improper Payments Elimination and Recovery Act of 2010 (IPERA),[42] which amends IPIA to expand upon the required steps for executive branch entities to identify, estimate, and report improper payment information. IPERA established additional requirements related to manager accountability, recovery auditing, compliance and noncompliance determinations and reporting, and an opinion on internal controls over improper payments. In general, the revised improper payment requirements established by IPERA become effective when OMB issues its implementing guidance, which is required no later than January 22, 2011. We view these actions as positive steps toward improving transparency over and reducing improper payments; however, it is too soon to determine whether the activities called for in the Executive Order, Presidential memoranda, and

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

IPERA will achieve their goal of reducing improper payments while continuing to ensure that federal programs serve and provide access to intended beneficiaries.

Information Security

Although progress has been made, serious and widespread information security control deficiencies 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. We have reported information security as a high-risk area across government since February 1997. During fiscal year 2010, federal entities reported control deficiencies related to preventing, limiting, or detecting unauthorized access to computing resources. Specifically, control deficiencies were identified related to (1) security management; (2) access to computer resources (data, equipment, and facilities) being reasonable and restricted to authorized individuals; (3) changes to information system resources being authorized and systems being configured and operating as intended; (4) segregation of incompatible duties; and (5) contingency planning for protecting information resources, minimizing the risk of unplanned interruptions, and providing for recovery of critical operations.

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 issuing extensive guidance on information security, reducing the number of federal access points to the Internet, and establishing security configurations for certain desktop computers. However, until entities identify and resolve information security control deficiencies and manage information security risks on an on-going basis, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2010, 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, these deficiencies indicate that internal controls over the financial reporting process were not effective to (1) ensure 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 and (2) support timely and reliable financial statements, accompanying notes, and required supplemental and other accompanying information without extensive supplemental procedures and adjustments.

APPENDIX IV

Significant Deficiencies

In addition to the material weaknesses discussed in appendices II and III, we found two significant deficiencies in internal control as described below. Also, the significant deficiency in fiscal year 2009 regarding verification procedures for data input for the Troubled Asset Relief Program equity investment and direct loan valuations is no longer considered to be a significant deficiency as of September 30, 2010.

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 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 agency 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. A previously reported control deficiency relating to mortgage-backed securities was resolved in fiscal year 2010.

Preparation of the Statement of Social Insurance

Deficiencies were identified in certain controls over spreadsheets used by the Department of Health and Human Services (HHS) to prepare its Statement of Social Insurance, including the lack of robust controls over spreadsheet changes and inputs that may result in output that varies from management's intentions. HHS, which administers the Medicare programs, contributes the majority of the amounts reported on the consolidated Statement of Social Insurance. Such control deficiencies could result in misstatements to the consolidated Statement of Social Insurance.

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