



U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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Comptroller General
of the United States

February 27, 2014

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

During fiscal year 2013, the federal government's reported unified budget deficit decreased by about \$409 billion to approximately \$680 billion. However, the federal government continues to face an unsustainable long-term fiscal path. To operate as effectively and efficiently as possible and to make difficult decisions to address the federal government's fiscal challenges, Congress, the administration, and federal managers must have ready access to reliable and complete financial and performance information—both for individual federal entities and for the federal government as a whole. Overall, significant progress has been made since the enactment of key federal financial management reforms in the 1990s; however, our report on the U.S. government's consolidated financial statements underscores that much work remains to improve federal financial management, and these improvements are urgently needed.

Our audit report on the U.S. government's consolidated financial statements is enclosed. In summary, we found the following:

- Certain material weaknesses¹ in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that prevented us from expressing an opinion on the accrual-based consolidated financial statements as of and for the fiscal years ended September 30, 2013, and 2012.² About 33 percent of the federal government's reported total assets as of September 30, 2013, and approximately 16 percent of the federal government's reported net cost for fiscal year 2013 relate to the Department of Defense (DOD), which received a disclaimer of opinion on its consolidated financial statements.
- Significant uncertainties, primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2013, 2012, 2011, and 2010 Statements of

¹A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting 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.

²The accrual-based consolidated financial statements as of and for the fiscal years ended September 30, 2013, and 2012 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 2013, 2012, 2011, 2010, and 2009 Statements of Social Insurance and the 2013 and 2012 Statements of Changes in Social Insurance Amounts, including the related notes, are also included in the consolidated financial statements.

Social Insurance, prevented us from expressing an opinion on those statements as well as on the 2013 and 2012 Statements of Changes in Social Insurance Amounts. About \$27.3 trillion, or 68.8 percent, of the reported total present value of future expenditures in excess of future revenue presented in the 2013 Statement of Social Insurance relates to Medicare programs reported in the Department of Health and Human Services' 2013 Statement of Social Insurance, which received a disclaimer of opinion.³

- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2013.
- Our tests of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year 2013 were limited by the material weaknesses and other scope limitations discussed in our audit report.

While significant progress has been made in improving federal financial management since the federal government began preparing consolidated financial statements 17 years ago, three major impediments continued to prevent us from rendering an opinion on the federal government's accrual-based consolidated financial statements over this period: (1) serious financial management problems at DOD that have prevented its financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and (3) the federal government's ineffective process for preparing the consolidated financial statements.

Importantly, almost all of the 24 Chief Financial Officers (CFO) Act agencies received unmodified ("clean") opinions on their respective entities' fiscal year 2013 financial statements, including the Department of Homeland Security (DHS). This was the first time that DHS has received an unmodified opinion on all of its financial statements—a significant achievement.

DOD, however, has consistently been unable to receive such an audit opinion on its financial statements. Following years of unsuccessful financial improvement efforts, the DOD Comptroller established the Financial Improvement and Audit Readiness (FIAR) Directorate to develop, manage, and implement a strategic approach for addressing internal control weaknesses and for achieving auditability, and to integrate those efforts with other improvement activities, such as the department's business systems modernization efforts. DOD's current FIAR strategy and methodology focus on two priorities—budgetary information and asset accountability—with an overall goal of

³We issued an unmodified opinion on the Statement of Social Insurance for 2009. Statements of Social Insurance are presented for the current year and each of the 4 preceding years in accordance with U.S. generally accepted accounting principles. Also, both the Statements of Social Insurance and the Statements of Changes in Social Insurance Amounts do not interrelate with the accrual-based consolidated financial statements.

preparing auditable department-wide financial statements by September 30, 2017.⁴ Because budgetary information is widely and regularly used for management, one of DOD's highest interim priorities is the improvement of its budgetary information and processes underlying its Statement of Budgetary Resources (SBR).

Based on difficulties encountered in auditing the SBR of the U.S. Marine Corps, DOD made a significant change to its FIAR Guidance that will limit the scope of the first-year SBR audits for all DOD components.⁵ As outlined in the March 2013 revised FIAR Guidance, the scope of the SBR audits beginning in fiscal year 2015 will be on budget activity only in the current year appropriations as an interim step toward achieving an audit of the SBR. In subsequent years, the components will commence audits of schedules of both current year and prior year audited appropriations and all related activity against those appropriated funds. DOD also reported this scope change in its May 2013 FIAR Plan Status Report and reiterated the department's commitment to achieving its audit readiness goals, but noted that absent a stable budget environment, DOD efforts were subject to increased risk.⁶ Moreover, the results of our prior work have raised concerns about the ability of DOD components to implement the FIAR Plan effectively.⁷

Various efforts are also under way to address the other two major impediments. During fiscal year 2013, the Department of the Treasury (Treasury) continued to actively work with federal entities to resolve intragovernmental differences. These efforts included expanding the implementation of a quarterly scorecard process⁸ to the 35 significant federal entities⁹ and encouraging the use of the dispute resolution process.¹⁰ In addition, Treasury further developed and began implementing a methodology to reconcile certain

⁴Section 1003 of the National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84, 123 Stat. 2190, 2439-41 (Oct. 28, 2009), made the development and maintenance of the FIAR Plan a statutory requirement. Under the act, the FIAR Plan must describe specific actions to be taken and the costs associated with ensuring that DOD's financial statements are validated as ready for audit by September 30, 2017. More recently, section 1005 of the National Defense Authorization Act for Fiscal Year 2013, Pub. L. No. 112-239, 126 Stat. 1632 (Jan. 2, 2013), added a new requirement for DOD's FIAR Plan to describe specific actions to be taken and the costs associated with ensuring that one of DOD's financial statements, the Statement of Budgetary Resources, is validated as ready for audit by September 30, 2014.

⁵The FIAR Guidance was first issued by the DOD Comptroller in May 2010 and provides a standardized methodology for DOD components to follow for achieving financial management improvements and auditability. The DOD Comptroller periodically updates this guidance.

⁶In accordance with the National Defense Authorization Act for fiscal year 2010, the DOD Comptroller provides reports to relevant congressional committees on the status of DOD's implementation of the FIAR Plan twice a year—no later than May 15 and November 15.

⁷GAO, *DOD Financial Management: Marine Corps Statement of Budgetary Resources Audit Results and Lessons Learned*, GAO-11-830 (Washington, D.C.: Sept. 15, 2011, reissued Oct. 17, 2011); *DOD Financial Management: Improvement Needed in DOD Components' Implementation of Audit Readiness Effort*, GAO-11-851 (Washington, D.C.: Sept. 13, 2011); and *DOD Financial Management: Ongoing Challenges with Reconciling Navy and Marine Corps Fund Balance with Treasury*, GAO-12-132 (Washington, D.C.: Dec. 20, 2011).

⁸For each quarter, Treasury produces a scorecard for each significant entity that reports various aspects of the entity's intragovernmental differences with its trading partners, including the composition of the differences by trading partner and category. Entities are expected to resolve, with the respective trading partners, the differences identified in their scorecards.

⁹The Office of Management and Budget and Treasury have identified 35 federal entities 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.

¹⁰When an entity and respective trading partner cannot resolve an intragovernmental difference, the entities must request Treasury to resolve the dispute. Treasury will review the dispute and issue a decision on how to resolve the difference, which the entities must follow.

outlays and receipts between Treasury's records used to compute the budget deficit reported in the consolidated financial statements and underlying federal entity financial information and records. To help address the numerous issues in these areas, it will be important that Treasury has adequate systems and personnel to address the magnitude of the issues, and that Treasury and the Office of Management and Budget (OMB) develop and implement adequate corrective action plans for addressing the internal control deficiencies involving the process for preparing the consolidated financial statements. In addition to continued leadership by Treasury and OMB, strong and sustained commitment by federal entities is critical to fully address the numerous issues in these areas.

The material weaknesses underlying these three major impediments 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 referred to above, we identified three other material weaknesses. These are the federal government's inability to (1) determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce them, (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and (3) effectively manage its tax collection activities. Additional details concerning these material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations are presented in our audit report. Until the problems outlined in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

The federal government reported a net operating cost of about \$805 billion for fiscal year 2013 compared to the approximate \$1.3 trillion reported for fiscal year 2012. Significant increases in taxes and other revenues and reductions in net costs were responsible for the decrease. The reported unified budget deficit of approximately \$680 billion for fiscal year 2013 was down from the approximate \$1.1 trillion reported for fiscal year 2012. The federal government's reported assets increased from about \$2.7 trillion as of September 30, 2012, to about \$3 trillion as of September 30, 2013, and its reported liabilities increased from about \$18.8 trillion to about \$19.9 trillion. Most of the increase in the federal government's assets and liabilities was due to student loans made by the Department of Education and a net increase in federal debt held by the public, respectively. As of September 30, 2013, federal debt held by the public totaled about 72 percent of gross domestic product (GDP).

While the federal government has significantly reduced the assets and liabilities related to actions it had taken to stabilize the financial markets and promote economic recovery during and after the last recession, the accrual-based consolidated financial statements, as of September 30, 2013, and 2012, continue to include significant equity investments in certain entities. For example, as of September 30, 2013, the reported investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan

Mortgage Corporation (Freddie Mac) totaled about \$140 billion (reported net of about \$54 billion in valuation reserves). In valuing these equity investments, 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, there are many factors affecting these assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of the 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, 2013, and the actual results, and such differences may be material.

In addition, there are risks that other factors could affect the federal government's financial condition in the future, including the following:

- The U.S. Postal Service (USPS) is facing a deteriorating financial situation with a lack of liquidity as it has reached its borrowing limit of \$15 billion and finished fiscal year 2013 with a reported net loss of \$5 billion.
- The Federal Housing Administration's (FHA) mortgage insurance portfolio continues to grow, and its insurance fund has experienced major financial difficulties. FHA's capital ratio for its Mutual Mortgage Insurance Fund remained below the required 2 percent level as of the end of fiscal year 2013. The ultimate roles of Fannie Mae and Freddie Mac in the mortgage market may further affect FHA's financial condition.
- The Pension Benefit Guaranty Corporation's (PBGC) financial future is uncertain because of long-term challenges related to PBGC's governance and funding structure. PBGC's liabilities exceeded its assets by about \$36 billion as of September 30, 2013. PBGC reported that it is subject to further losses if plan terminations that are reasonably possible occur.
- Several initiatives undertaken during the last 5 years by the Board of Governors of the Federal Reserve System to stabilize the financial markets have led to a significant change in the composition and size of reported securities on the Federal Reserve's balance sheet. The value of these securities, which include Treasury securities and mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association (Ginnie Mae), is subject to interest rate risk and may decline or increase depending on interest rate changes. If the Federal Reserve sells these securities at a loss, future payments of Federal Reserve earnings to the federal government may be reduced.¹¹

GAO's High-Risk list includes several of these issues, such as information security, USPS's business model, DOD financial management, and the PBGC and FHA insurance programs.¹² Every 2 years, GAO provides Congress with an update on its High-Risk Series, which highlights federal entities and program areas that are high risk due to their vulnerabilities to fraud, waste, abuse, and mismanagement or are most in need of broad reform. We updated our High-Risk Series in early 2013.

¹¹Under Federal Reserve System policy, excess Federal Reserve Bank earnings are paid to the federal government. The federal government reported such net earnings of about \$76 billion for fiscal year 2013, still well above its historical levels.

¹²GAO, *High-Risk Series: An Update*, GAO-13-283 (Washington, D.C.: February 2013).

Increased attention to risks that could affect the federal government's financial condition is made more important because of the nation's longer-term fiscal challenges. The comprehensive long-term fiscal projections presented in the unaudited Required Supplementary Information section of the *Fiscal Year 2013 Financial Report of the United States Government (2013 Financial Report)* show that—absent policy changes—the federal government continues to face an unsustainable long-term fiscal path. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare benefits. Under these projections, spending for the major health and retirement programs will increase in coming decades as more members of the baby-boom generation become eligible for benefits and the health care cost for each enrollee increases. Over the long term, the imbalance between spending and revenue that is built into current law and policy will lead to continued growth of debt held by the public as a share of GDP. This situation—in which debt grows faster than GDP—means the current federal fiscal path is unsustainable. Further, without legislative action, the Social Security Disability Insurance Trust Fund's assets are projected to be exhausted in 2016, at which time the Social Security Administration would need to reduce benefits consistent with available funds.

These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. If, however, the cost containment measures are not sustained over the long term—a concern expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow much more rapidly.

GAO also prepares long-term federal fiscal simulations, which continue to show debt rising as a share of GDP.¹³ Under GAO's Alternative simulation,¹⁴ which uses the CMS Office of the Actuary's alternative health care cost projections, future spending in excess of receipts would be greater and debt held by the public as a share of GDP would grow more quickly than the projections in the *2013 Financial Report*.

¹³GAO, *The Federal Government's Long-Term Fiscal Outlook: Spring 2013 Update*, GAO-13-481SP (Washington, D.C.: Apr. 11, 2013).

¹⁴GAO's Spring 2013 Alternative simulation incorporates the CMS Office of the Actuary's alternative projections for health care cost growth, which assume physician payments are not reduced as specified under current law and certain cost controls are not maintained over the long term. Also in this simulation, expiring tax provisions, such as the research and experimentation tax credit, are extended to 2023. In the Alternative simulation, discretionary spending follows the original discretionary spending caps set by the Budget Control Act of 2011 but not the lower caps triggered by the automatic enforcement procedures. Over the long term, discretionary spending and revenue are held at their historical average share of GDP.

The Bipartisan Budget Act of 2013 (budget agreement),¹⁵ which amended the Balanced Budget and Emergency Deficit Control Act (BBEDCA),¹⁶ established new (higher) limits on defense and nondefense discretionary appropriations for fiscal years 2014 and 2015, extended sequestration for direct spending programs by 2 years through fiscal year 2023, and made other changes to direct spending and revenue. As a result, the budget agreement is projected to reduce the deficit over the next 10 years, but would not make a significant change in the long-term outlook for the federal budget.

Reliable financial and performance information is even more critical as (1) federal managers likely face increasingly tight budget constraints and need to operate their respective entities as efficiently and effectively as possible and (2) decision makers carry out the important task of deciding how to use multiple tools (tax provisions, discretionary spending, mandatory spending, and credit programs) to address the federal government's fiscal challenges.

As we reported in December 2013, Treasury twice deviated from its normal debt management operations during fiscal year 2013, for almost half the fiscal year, due to delays in raising the debt limit.¹⁷ During those delays, Treasury took a number of extraordinary actions—consistent with relevant laws and regulations—to avoid exceeding the debt limit. The first delay occurred from December 31, 2012, through February 3, 2013. On February 4, 2013, the debt limit was suspended through May 18, 2013, by the No Budget, No Pay Act of 2013.¹⁸ The second delay occurred from May 20, 2013, through October 16, 2013. On October 17, 2013, the debt limit was suspended through February 7, 2014, by the Continuing Appropriations Act, 2014.¹⁹ On February 15, 2014, the debt limit was suspended through March 15, 2015, by the Temporary Debt Limit Extension Act.²⁰

As we have previously reported, the debt limit does not restrict Congress's ability to enact spending and revenue legislation that affects the level of federal debt or otherwise constrains fiscal policy; it restricts Treasury's authority to borrow to finance the decisions already enacted by Congress and the President.²¹ The United States benefits from the confidence investors have that debt backed by the full faith and credit of the United

¹⁵Pub. L. No. 113-67, div. A, tit. I, § 101, 127 Stat. 1165, 1166-69 (Dec. 26, 2013). The Continuing Appropriations Act, 2014, Pub. L. No. 113-76, 128 Stat. 5 (Jan. 17, 2014), enacted discretionary appropriations for fiscal year 2014 consistent with the limits established in the budget agreement and the Balanced Budget and Emergency Deficit Control Act (BBEDCA), as amended.

¹⁶The Budget Control Act of 2011, Pub. L. No. 112-25, 125 Stat. 240 (Aug. 2, 2011), which amended BBEDCA, imposed discretionary spending limits for fiscal years 2012 through 2021 to reduce projected spending by about \$1 trillion. The Budget Control Act also established the Joint Select Committee on Deficit Reduction, which was tasked with proposing legislation to reduce the deficit by an additional \$1.2 trillion through fiscal year 2021. The Joint Committee did not report a proposal, and Congress and the President did not enact legislation. This triggered the sequestration process in section 251A of BBEDCA, which is classified, as amended, at 2 U.S.C. § 901a. Section 251A also provides for an annual reduction of the discretionary spending limits and a sequestration of direct spending from fiscal years 2014 through 2021. The budget agreement enacted further changes amending section 251A of BBEDCA.

¹⁷GAO, *Financial Audit: Bureau of the Fiscal Service's Fiscal Years 2013 and 2012 Schedules of Federal Debt*, GAO-14-173 (Washington, D.C.: Dec. 12, 2013).

¹⁸Pub. L. No. 113-3, § 2, 127 Stat. 51 (Feb. 4, 2013).

¹⁹Pub. L. No. 113-46, § 1002, 127 Stat. 558, 566-67 (Oct. 17, 2013).

²⁰Pub. L. No. 113-83, § 2, 128 Stat. 1011 (Feb. 15, 2014).

²¹GAO, *Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs*, GAO-12-701 (Washington, D.C.: July 23, 2012), and *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, GAO-11-203 (Washington, D.C.: Feb. 22, 2011).

States will be honored. As we have also previously reported, delays in raising the debt limit can create uncertainty in the Treasury market and lead to higher Treasury borrowing costs. To avoid such uncertainty and related borrowing costs, we noted, in our February 2011 and July 2012 reports related to the debt limit, that Congress should consider ways to better link decisions about the debt limit with decisions about spending and revenue at the time those decisions are made to avoid potential disruptions to the Treasury market and to help inform the fiscal policy debate in a timely way.

Our audit report on the U.S. government's consolidated financial statements would not be possible without the commitment and professionalism of inspectors general throughout the federal government who are responsible for annually auditing the financial statements of individual federal entities. We also appreciate the cooperation and assistance of Treasury and OMB officials as well as the federal entities' chief financial officers. We look forward to continuing to work with these individuals, the administration, and Congress to achieve the goals and objectives of federal financial management reform.

Our audit report begins on page 220. Our guide to the *Financial Report of the United States Government (Financial Report)* is intended to help those who seek to obtain a better understanding of the *Financial Report* and is available on GAO's website at www.gao.gov.²² In addition, the website includes a guide to understanding the differences between accrual and cash measures of the deficit and provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.²³

²²GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-946SP (Washington, D.C.: September 2009).

²³See <http://www.gao.gov/special.pubs/longterm/deficit/>, which is based on information in GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006). In January 2007 and 2008, we issued updates to this guide for fiscal years 2006 and 2007; see GAO-07-341SP (Washington, D.C.: January 2007) and GAO-08-410SP (Washington, D.C.: January 2008).

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

A handwritten signature in black ink, reading "Gene L. Dodaro". The signature is written in a cursive style with a large, prominent initial "D".

Gene L. Dodaro
Comptroller General
of the United States

cc: The Majority Leader of the Senate
The Minority Leader of the Senate
The Majority Leader of the House of Representatives
The Minority Leader of the House of Representatives