

Under the Trustees' intermediate set of assumptions, and as displayed in the Statement of Social Insurance, the SMI situation over the 75-year period is entirely different from HI projections due to the financing explained above. The projected future expenditures for Part B will be \$17,613 billion (\$17.6 trillion) and Part D expenditures will be \$10,250 billion (\$10.3 trillion). This compares to FY 2005 projections of \$16,571 billion (\$16.6 trillion) and \$11,233 billion (\$11.2 trillion). A substantial level of uncertainty surrounds these projections pending the availability of sufficient data, especially on Part D expenditures, to help establish a trend baseline. Also, the reader must take into consideration that estimates have been made on the assumption that the trust fund will continue to operate without change in current law.

Limitations of the Principal Financial Statements

The principal financial statements in Section III of this report have been prepared to report the financial position and results of operations of HHS, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of HHS in accordance with generally accepted accounting principles (GAAP) for Federal entities and the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Systems, Controls, and Legal Compliance

The Department's overall goals for its financial management systems focus on ensuring effective internal controls, systems integration, and timely and reliable financial and performance data for reporting. One of the Department's immediate priorities is to address weaknesses that are identified in audits, evaluations, and assessments of its financial management controls, systems, and processes.

Systems

A cornerstone to improving HHS management practices is the Department's ability to maintain management systems, processes, and controls that ensure financial accountability; provide useful management information; and meet requirements of Federal laws, regulations, and guidance. HHS seeks to comply with a variety of Federal financial management systems requirements, including those articulated by the Federal Managers' Financial Integrity Act (FMFIA), the Chief Financial Officers Act, the Government Management Reform Act, the Clinger-Cohen Act of 1996, the Federal Financial Management Improvement Act (FFMIA), as well as the Office of Management and Budget (OMB) Circular No. A-127, Financial Management Systems. This section includes an overview of HHS' current key systems and the Department's implementation of a Unified Financial Management System (UFMS).

System Goals and Strategies

The HHS will use Oracle Federal Financials as the foundation for integrating financial management across the Department. Through UFMS, HHS seeks to establish a unified approach for enhancing financial management performance by eliminating duplication, streamlining processes, and establishing a common information technology (IT) infrastructure across the enterprise. In addition, it seeks to retain a clean audit opinion and meet the standards for success in getting to green under the President's Management Agenda initiative "Improved Financial Performance."

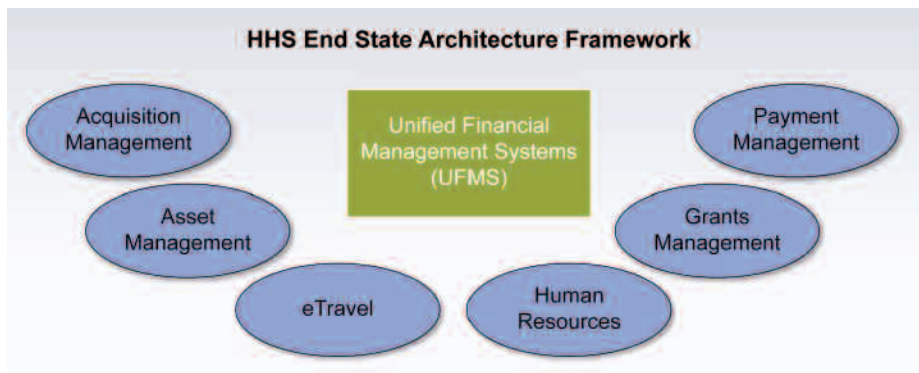
HHS' existing enterprise architecture for financial management in the Department consists of disparate, decentralized reporting systems, which are mainframe-based, rely on a mix of manual and automated processes, and are supported by varying functional and technical practices among component agencies. Since HHS and its supporting components implemented these systems, both the executive and legislative branches of the Federal Government have implemented statutes and regulations to enhance accountability and results through improved financial management. Central agencies such as OMB and the Department of the Treasury, and the Federal Accounting Standards Advisory Board have issued financial management policies, standards, and other mandates that require improvements in Federal financial management systems.

For several years, the Department has received unqualified opinions on its financial statements. However, it has been reported that the underlying financial systems that assist in the preparation of financial statements and reports do not meet all applicable requirements. To correct this situation, the Department embarked on a program to implement a UFMS.

The UFMS will replace five legacy accounting systems (PSC’s CORE Accounting System, CDC’s TOPS, FDA’s GLAS, NIH’s CAS, and CMS’ FACS) with a web-based, commercial, off-the-shelf product. Once fully implemented, UFMS will reduce the legacy systems to one modern accounting system, with two components: The Healthcare Integrated General Ledger Accounting System (HIGLAS) will support CMS and the Medicare contractors and UFMS Global will serve the rest of the Department. The UFMS will:

- produce information that is timely, useful, and reliable and will support the integration of financial and performance information;
- produce the information that program managers and decision-makers will need in a timely manner and will provide the real-time processes needed to support effective e-Gov initiatives;
- result in streamlining critical administrative systems that impact financial management functions, including grants and acquisition; and
- strengthen internal controls by instituting standard business rules, data requirements, and accounting policies across the board.

In conjunction with these internal streamlining efforts, the Department will continue to ensure coordination with e-Gov initiatives efforts such as e-Travel, e-Payroll, e-Procurement, and Grants.gov. Once UFMS is fully implemented, the HHS financial management systems framework will be as depicted below:



Statement of Auditing Standards (SAS) No. 70 Service Organization

HHS has annually contracted for independent examinations of the Department’s service providers to be performed under the guidelines of the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standard (SAS) Number 70, Service Organizations as amended. In FY 2006, examinations of the Program Support Center’s Division of Payment Management System, Enterprise Support Services and Division of Financial Operations, and the National Institutes of Health’s Center for Information Technology service organizations were performed. The examinations were “Type 2” reports that provided an opinion on the description of controls, whether the control descriptions were suitably designed to achieve the control objectives, and if the controls had been placed in operation for the period October 1, 2005 to June 30, 2006. The independent auditors noted exceptions where (1) certain controls were not suitably designed and/or (2) certain controls were not operating effectively. These conditions resulted in the conclusion that some control objectives were not achieved. The Department is in the process of developing and/or implementing plans and systems to address deficiencies identified in these examinations.

Management Assurance

The Department of Health and Human Services' (HHS) management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA) and OMB Circular No. A-123, *Management's Responsibility for Internal Control*, dated December 21, 2004. These objectives are to ensure: 1) effective and efficient operations; 2) compliance with applicable laws and regulations; and 3) reliable financial reporting.

As required by OMB Circular No. A-123, *Management's Responsibility for Internal Control*, HHS has evaluated its internal controls and financial management systems to determine whether these objectives are being met. Accordingly, HHS provides a qualified statement of assurance that its internal controls and financial systems meet the objectives of FMFIA, except for the following three material weaknesses, two of which also constitute nonconformances under Section 4 of FMFIA:

1. Medicare Advantage and Prescription Drug Benefit Payments;
2. Financial Systems and Processes (nonconformance); and
3. Medicare Electronic Data Processing Operations (nonconformance).

Assurance for Internal Control over Operations and Compliance

HHS conducted its assessment of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular No. A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation, HHS identified one material weakness in its internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations, under Section 2 of FMFIA relating to Medicare electronic data processing operations, which also constitutes a nonconformance under Section 4 of FMFIA as of September 30, 2006. Other than the exceptions described in Attachment I, the internal controls over operations and compliance with applicable laws and regulations as of September 30, 2006, were operating effectively and no other material weaknesses were found in the design or operation of these internal controls.

Assurance for Internal Control over Financial Reporting

HHS conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular No. A-123, *Management's Responsibility for Internal Control*. Based on the results of this assessment, HHS identified two material weaknesses in its internal control over financial reporting as of June 30, 2006, relating to the (1) Medicare Advantage and Prescription Drug Benefit payments; and (2) Department's financial systems and processes, which also constitutes a nonconformance under Section 4 of FMFIA. Other than the exceptions described in Attachment I, the internal controls over financial reporting as of June 30, 2006, were operating effectively and no other material weaknesses were found in the design or operation of the internal control over financial reporting.



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Summary of Material Weaknesses/Systems Nonconformances

Control Area	Material Weaknesses by Control Objective under Section 2 of FMFIA			Nonconformance under Section 4 of FMFIA (as of 9/30/06)
	Operations (as of 9/30/06)	Compliance (as of 9/30/06)	Financial Reporting (as of 6/30/06)	
I. Medicare Advantage & Prescription Drug Benefit Payments	-	-	X	-
II. Financial Systems and Processes	-	-	X	X
III. Medicare Electronic Data Processing Operations	X	-	-	X

I. Medicare Advantage and Prescription Drug Benefit Payments

HHS lacks a comprehensive control environment related to the Medicare Advantage and the Prescription Drug Benefit payment cycles administered by the Centers for Medicare and Medicaid Services (CMS). The lack of integration of accounting processes within operating procedures and a comprehensive methodology for implementation of new payment systems related to Medicare Advantage and prescription drug organizations establishes an environment where the high internal control risk is not sufficiently mitigated.

The internal controls over financial reporting related to Medicare Advantage and Prescription Drug Benefit payments were not tested during FY 2006. Management made a business decision to focus on remediation of the previously identified outstanding material weakness related to Medicare Advantage payments and implementation of the new prescription drug program that use the same payment system. HHS has focused on identifying mitigating controls and new processes that would improve the effectiveness of internal controls in the Medicare Advantage and Prescription Drug Benefit payments area.

II. Financial Systems and Processes

HHS' financial management systems are not in substantial compliance with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996 because they do not fully comply with the Federal financial management systems requirements of OMB Circular A-127 and the United States Standard General Ledger (USSGL) at the transaction level.

As in prior years, HHS continues to have internal control weaknesses in its financial management systems and processes for producing financial statements. While progress is being made, the lack of an integrated financial management system and weaknesses in internal controls make it difficult for HHS to prepare timely and reliable financial statements. Substantial manual processes, significant adjustments to reported balances, and numerous accounting entries recorded outside the general ledger system are needed to produce the financial statements. HHS is implementing the Unified Financial Management System (UFMS) to integrate Department-wide financial management systems and operations by aligning HHS' businesses with modern technological capabilities.

III. Medicare Electronic Data Processing Operations

Internal control weaknesses were noted at the Centers for Medicare and Medicaid Services (CMS) central office and contractor sites related to electronic data processing operations. Findings were identified in logical access controls; application security, development and program change control; and systems software. This control area was reported as a reportable condition under "Medicare Electronic Data Processing Access Controls and Application Software Development and Change Control" in the Department's FY 2005 internal control report.

To strengthen internal controls in this area, the Department will implement a comprehensive strategy by focusing efforts on both short and mid-term actions needed to correct the deficiencies. Further, a comprehensive strategy will be implemented to correct individual findings at each of the contractor sites.

Corrective Action Plan and Impact of Material Weakness

The following table lists the corrective actions for the control weaknesses, the related corrective action date, and the Impact of the material weakness on the Financial Statements.

Material Weakness and Corrective Action Plan	Corrective Action Date	Impact of Control Weakness on Financial Statements
(1) Medicare Advantage and Prescription Drug Benefit Payments —Develop procedures to review and process payments, document procedures which determine eligibility of organizations, and improve oversight of providers.	Continuing throughout FY 2007	The risk level has been reduced by identifying and applying mitigating controls and new processes which have improved the effectiveness of internal controls in this area.
(2) Financial Systems and Processes— Complete implementation of UFMS.	Continuing throughout FY 2007, FY 2008 and FY 2009	The risk level has been reduced with compensating manual effort and controls.
(3) Medicare Electronic Data Processing (EDP) Operations—Implement a comprehensive strategy by focusing efforts on both short and mid-term actions to correct findings.	Continuing throughout FY 2007 and FY 2008	The risk level is reduced with the corrective action that has and is being implemented in connection with the Department’s Medicare error rate determination and other activities engaged in to reduce risk.

Legal Compliance

Improper Payments Information Act of 2002

The Improper Payments Information Act of 2002 requires that the Department annually review all programs and activities that it administers and identify all such programs and activities that may be susceptible to significant improper payments. For high risk programs, the Act requires that the Department report improper payment estimates and various other related data. During FY 2006, the Department conducted reviews of its programs and activities, continued to engage in recovery auditing activity and made progress in developing and/or implementing methodologies for estimating improper payments for its seven high risk programs. However, since the Department is continuing to work on methodologies to estimate improper payments for several of its programs, it does not yet comply with the Act. Detailed information on the Department’s activities to comply with the Improper Payments Information Act can be found in Section IV.

Federal Financial Management Improvement Act (FFMIA)

The FFMIA requires agencies to have financial management systems that substantially comply with the Federal financial management systems requirements, standards promulgated by the Federal Accounting Standards Advisory Board (FASAB), and the U.S. Standard General Ledger at the transaction level. Financial management systems shall have general and application controls in place in order to support management decisions by providing timely and reliable data. The agency head shall make a determination annually about whether the agency’s financial management systems substantially comply with the FFMIA. If the systems are found not to be compliant, management shall develop a remediation plan to bring those systems into substantial compliance. Management shall determine whether noncompliances with FFMIA should also be reported as nonconformances with Section 4 of FFMIA.

As reported in the Department’s management assurance letter, the Department does not comply with FFMIA.