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House of Representatives

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**FISCAL YEAR 2005  
U.S. GOVERNMENT  
FINANCIAL STATEMENTS**

**Sustained Improvement in  
Federal Financial  
Management Is Crucial to  
Addressing Our Nation's  
Financial Condition and  
Long-term Fiscal Imbalance**

Statement of David M. Walker  
Comptroller General of the United States





Highlights of [GAO-06-406T](#), testimony before the Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives

## Why GAO Did This Study

GAO is required by law to annually audit the consolidated financial statements of the U.S. government. The Congress and the President need to have timely, reliable, and useful financial and performance information. Sound decisions on the current results and future direction of vital federal government programs and policies are made more difficult without such information.

Until the problems discussed in GAO's audit report on the U.S. government's consolidated financial statements are adequately addressed, they will continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other 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 economical, efficient, and effective manner.

[www.gao.gov/cgi-bin/getrpt?GAO-06-406T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-406T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeffrey C. Steinhoff or Gary T. Engel at (202) 512-2600.

# FISCAL YEAR 2005 U.S. GOVERNMENT FINANCIAL STATEMENTS

## Sustained Improvement in Federal Financial Management Is Crucial to Addressing Our Nation's Financial Condition and Long-term Fiscal Imbalance

### What GAO Found

For the ninth consecutive year, certain material weaknesses in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent GAO from being able to provide the Congress and American people an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles. Three major impediments to an opinion on the consolidated financial statements continued to be (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Further, in our opinion, as of September 30, 2005, the federal government did not maintain effective internal control over financial reporting and compliance with significant laws and regulations due to numerous material weaknesses.

More troubling still is the federal government's overall financial condition and long-term fiscal imbalance. While the fiscal year 2005 budget deficit was lower than 2004, it was still very high, especially given the impending retirement of the "baby boom" generation and rising health care costs. Importantly, as reported in the fiscal year 2005 *Financial Report of the United States Government*, the federal government's accrual-based net operating cost—the cost to operate the federal government—increased to \$760 billion in fiscal year 2005 from \$616 billion in fiscal year 2004. This represents an increase of about \$144 billion or 23 percent. The federal government's gross debt was about \$8 trillion as of September 30, 2005. This number excludes such items as the gap between the present value of future promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other liabilities, commitments, and contingencies that the federal government has pledged to support. Including these items, the federal government's fiscal exposures now total more than \$46 trillion, representing close to four times gross domestic product (GDP) in fiscal year 2005 and up from about \$20 trillion or two times GDP in 2000. Given these and other factors, a fundamental reexamination of major spending programs, tax policies, and government priorities will be important and necessary to put us on a prudent and sustainable fiscal path. This will likely require a national discussion about what Americans want from their government and how much they are willing to pay for those things.

We continue to have concerns about the identification of misstatements in federal agencies' prior year financial statements. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. The material internal control weaknesses discussed in this testimony serve to increase the risk that additional errors may occur and not be identified on a timely basis by agency management or their auditors, resulting in further restatements.

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Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today and commend your subcommittee's tradition of oversight hearings on this and other financial management issues throughout the year. Such hearings continue to play a vital role in ensuring that the federal government is held accountable to the American people. Today I will discuss our report on the U.S. government's consolidated financial statements for fiscal years 2005 and 2004. Our work was conducted in accordance with U.S. generally accepted government auditing standards.

Both the consolidated financial statements and our report on them are included in the fiscal year 2005 *Financial Report of the United States Government*. This most recent report was issued by the Department of the Treasury (Treasury) on December 15, 2005, and is available through GAO's Internet site, at [www.gao.gov/financial/fy2005financialreport.html](http://www.gao.gov/financial/fy2005financialreport.html), and Treasury's Internet site, at [www.fms.treas.gov/fr/index.html](http://www.fms.treas.gov/fr/index.html). I also would like to highlight a guide we issued in September 2005 titled *Understanding the Primary Components of the Annual Financial Report of the United States Government*,<sup>1</sup> which was prepared to help those who seek to obtain a better understanding of the Financial Report. This guide can also be found on GAO's Internet site at [www.gao.gov/financial/fy2005/guidetofrofusg.pdf](http://www.gao.gov/financial/fy2005/guidetofrofusg.pdf).

For the ninth consecutive year, certain material weaknesses<sup>2</sup> in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent us from being able to provide the Congress and American people an opinion as to whether the consolidated financial statements of the U.S. government were fairly stated in conformity with U.S. generally accepted accounting principles (GAAP). Further, we also reported that the federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2005. Until the problems that I will discuss today and

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<sup>1</sup>GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005).

<sup>2</sup>A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

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that are discussed in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

More troubling still is the federal government's overall financial condition and long-term fiscal imbalance. While the fiscal year 2005 budget deficit was lower than 2004, it was still very high, especially given the impending retirement of the "baby boom" generation and rising health care costs. Importantly, as reported in the fiscal year 2005 *Financial Report of the United States Government*, the federal government's accrual-based net operating cost—that is, the cost to operate the federal government—increased to \$760 billion in fiscal year 2005 from \$616 billion in fiscal year 2004. This represents an increase of about \$144 billion or 23 percent. To make matters worse, the federal government's liabilities and unfunded commitments, which include military and civilian retirement benefits and promised Social Security and Medicare payments, are growing rapidly. Simply put, our nation's financial condition and long-term fiscal imbalance is on an imprudent and unsustainable course.

In this testimony, I will discuss (1) the federal government's long-term fiscal imbalance, (2) our continued concerns about the identification of misstatements in federal agencies' prior year financial statements, and (3) the major issues relating to the consolidated financial statements for fiscal years 2005 and 2004. I will also discuss systems problems that continue to hinder federal agency accountability, and describe progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements.

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## The Nation's Fiscal Imbalance

The *Financial Report of the United States Government* provides useful information on the government's financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation's fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal imbalance of the government—that is, the sustainability of the federal government's programs, commitments, and responsibilities in relation to the resources expected to be available. More important than the large increase in the government's net operating cost in fiscal year 2005 and persistent short-term budget deficits, fiscal simulations by GAO and others show that over the long term, we face large and growing structural deficits due primarily to known demographic trends, rising health care costs, and lower federal revenues relative to the economy.

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As I have testified before, the current financial reporting model does not clearly, comprehensively, and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it provides a potentially unrealistic and misleading picture of the federal government's overall performance, financial condition, and future fiscal outlook. The federal government's gross debt<sup>3</sup> in the U.S. government's consolidated financial statements was about \$8 trillion as of September 30, 2005.<sup>4</sup> This number excludes such items as the current gap between the present value of future promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other liabilities (e.g., federal employee and veteran benefits payable), commitments, and contingencies that the federal government has pledged to support.<sup>5</sup> Including these items, the federal government's fiscal exposures now total more than \$46 trillion, representing close to four times gross domestic product (GDP) in fiscal year 2005 and up from about \$20 trillion or two times GDP in 2000. About one third of the approximately \$26 trillion increase resulted from enactment of the Medicare prescription drug benefit in fiscal year 2004. (See table 1.) The federal government's current fiscal exposures translate into a burden of about \$156,000 per American or approximately \$375,000 per full-time worker, up from \$72,000 and \$165,000 respectively, in 2000. Furthermore, these amounts do not include future costs resulting from Hurricane Katrina or the conflicts in Iraq and Afghanistan.

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<sup>3</sup>The federal government's gross debt consists of debt held by the public and intragovernmental debt holdings.

<sup>4</sup>On December 29, 2005, the Secretary of the Treasury (Secretary) notified the Congress that the statutory debt limit will be reached in mid-February 2006. On February 16, 2006, to avoid exceeding the debt limit, the Secretary began suspending investments in the Government Securities Investment Fund of the Federal Employees' Retirement System (G-Fund) and also suspended the sales of State and Local Government Series securities (SLGS).

<sup>5</sup>A broader discussion of fiscal exposures can be found in GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, [GAO-03-213](#) (Washington, D.C.: Jan. 24, 2003).

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**Table 1: Estimated Fiscal Exposures**

Dollars in trillions		
	2000	2005
<b>Explicit liabilities</b>	<b>\$6.9</b>	<b>\$9.9</b>
• Publicly held debt		
• Military & civilian pensions & retiree health		
• Other		
<b>Commitments &amp; contingencies</b>	<b>0.5</b>	<b>0.9</b>
• E.g., Pension Benefit Guarantee Corporation, undelivered orders		
<b>Implicit exposures</b>	<b>13.0</b>	<b>35.6</b>
• Future Social Security benefits	3.8	5.7
• Future Medicare Part A benefits	2.7	8.8
• Future Medicare Part B benefits	6.5	12.4
• Future Medicare Part D benefits	--	8.7
<b>Total</b>	<b>\$20.4</b>	<b>\$46.4</b>

Source: U.S. government's consolidated financial statements (CFS).

Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year as reported in the CFS and all other data are as of September 30.

In addition to the approximately \$46 trillion of estimated fiscal exposures discussed above, there are exposures that are not included in those figures because the amounts of the exposures are not currently estimable. For example, the Department of Energy, in the footnotes to its fiscal year 2005 financial statements, disclosed that its environmental liability estimates do not include cleanup costs at sites for which there is no current feasible remediation approach, such as the nuclear explosion test area at the Nevada Test Site. It is important to understand the nature and extent of these types of additional exposures in the long-term fiscal planning for the federal government.<sup>6</sup>

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<sup>6</sup>For information on how agencies could better recognize, in the budget, the full costs of environmental cleanup and disposal associated with asset acquisitions, see GAO, *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities*, [GAO-03-219](#) (Washington, D.C.: Jan. 24, 2003). Also, at the request of this subcommittee and the House Subcommittee on Energy and Resources, Committee on Government Reform, GAO has ongoing work assessing the adequacy of agency processes and controls for estimating environmental liabilities and the nature and type of uncertainties that could impact the ultimate cost of cleanup. Our report on this study is expected to be issued by the end of this month.

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Additionally, tax expenditure amounts are not required to be disclosed, nor are they disclosed, in agency or the U.S. government's consolidated financial statements. Tax expenditures are reductions in tax revenues that result from preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses reduce the resources available to fund other programs or they require higher tax rates to raise a given amount of revenue. As we reported in September 2005, the number of tax expenditures more than doubled since 1974, and the sum of tax expenditure revenue loss estimates tripled in real terms to nearly \$730 billion in 2004.<sup>7</sup> Under the most recent estimates, this has risen to more than \$775 billion in 2005. Enhanced reporting on tax expenditures would ensure greater transparency and accountability for revenue forgone by the federal government and provide a more comprehensive picture of the federal government's policies and fiscal position.

Further, additional changes are needed to communicate important information to users about current operating results and the long-term financial condition of the U.S. government and annual changes therein. In particular, the government's financial statements should clearly communicate to the user:

- the on-budget or operating results versus unified budget results for the year;
- the long-term sustainability of federal government programs—areas to consider include
  - the relationship of the federal government's existing commitments/responsibilities, including social insurance, to appropriate measures, such as GDP and per capita amounts,
  - the government's long-term fiscal imbalance in relation to appropriate measures, such as GDP, and
  - the magnitude of the potential alternatives for resolving the long term deficits, such as the rate of tax increases or spending reductions necessary to balance the government's long-term finances;

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<sup>7</sup>The sum of individual tax expenditure estimates is useful for gauging the general magnitude of the revenue involved, but does not take into account possible interactions between individual provisions. For additional information, see GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, [GAO-05-690](#) (Washington, D.C.: September 2005).

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- inter-generational equity issues, e.g., assessing the extent to which different age groups may be required to assume financial burdens for commitments already made; and
  - a liability at the governmentwide level for funds held by Social Insurance trust funds.

Another tool that would serve to more effectively communicate the federal government's finances to the public would be a Summary Annual Report. Such a report would summarize, in a clear, concise, and transparent manner, key financial and performance information included in the *Financial Report of the United States Government*.

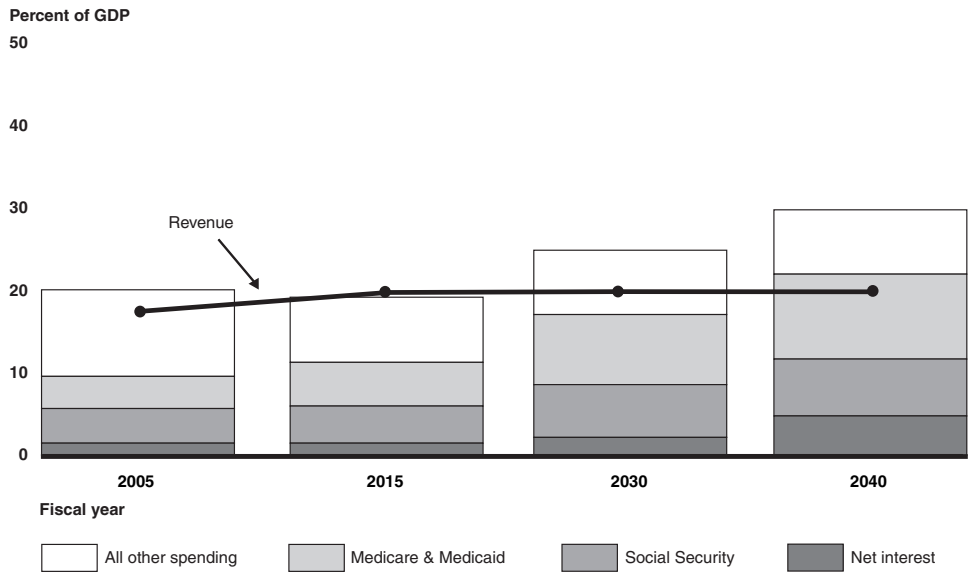
The federal government's financial condition and long-term fiscal imbalance present enormous challenges to the nation's ability to respond to emerging forces reshaping American society, the United States' place in the world, and the future role of the federal government. GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Figures 1 and 2 present these simulations under two different sets of assumptions. In figure 1, we start with the Congressional Budget Office's (CBO) 10-year baseline—constructed according to the statutory requirements for that baseline.<sup>8</sup> Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and all tax cuts currently scheduled to expire are assumed to expire. After 2016, discretionary spending is assumed to grow at the same rate as the economy, and revenue is held constant as a share of GDP at the 2016 level. In figure 2, two assumptions are changed: (1) discretionary spending is assumed to grow at the same rate as the economy after 2006 rather than merely with inflation, and (2) all expiring tax provisions are extended. For both simulations, Social Security and Medicare spending is based on the 2005 Trustees' intermediate cost projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2005 long-term projections under midrange assumptions.

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<sup>8</sup>The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (Washington, D.C.: January 2006).



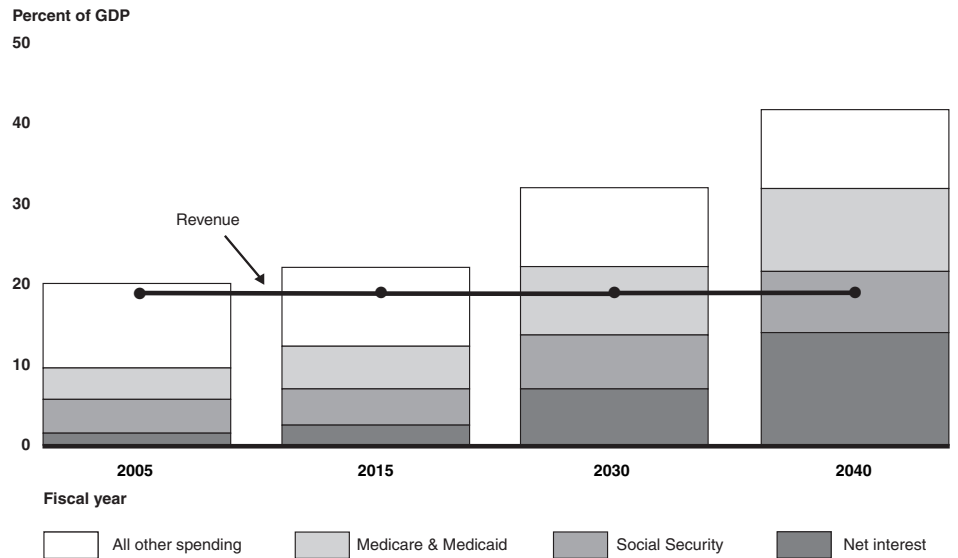
**Figure 1: Composition of Spending as a Share of GDP under Baseline Extended**



Source: GAO's January 2006 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

**Figure 2: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended**



Source: GAO's January 2006 analysis.

Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.

As these simulations illustrate, absent policy changes on the spending or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that all the temporary tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues would be adequate to pay only some Social Security benefits and interest on the federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance.

Although revenues will be part of the debate about our fiscal future, assuming no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems to be highly implausible. Accordingly, substantive reform of Social Security and our major health programs is critical to recapturing our future fiscal flexibility. Ultimately, the nation will have to decide what level of federal benefits and spending it wants and how it will pay for these benefits. Our current path also will increasingly constrain

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our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by future generations. Continuing on this fiscal path will mean escalating and ultimately unsustainable federal deficits and debt that will serve to threaten the standard of living for the American people and ultimately our national security.

As these simulations illustrate, regardless of the assumptions used, the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination, reprioritization, and reengineering of major spending programs, tax policies, and government priorities will be important to recapture our fiscal flexibility and update our programs and priorities to respond to emerging social, economic, and security changes. Ultimately, this will likely require a national discussion about what Americans want from their government and how much they are willing to pay for those things.

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## Restatements of Agencies' Financial Statements

According to Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior period financial statements presented should only be restated for corrections of errors, when such errors caused the financial statements to be materially misstated. Errors in financial statements can result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.

We continue to have concerns about the identification of misstatements in federal agencies' prior year financial statements. At least 7<sup>9</sup> of the 24 CFO Act agencies restated certain of their fiscal year 2004 financial statements to correct errors. During fiscal year 2005, we reviewed the causes and nature of the restatements made by several Chief Financial Officers (CFO) Act agencies in fiscal year 2004 to their fiscal year 2003 financial statements and recommended improvements in internal controls and audit

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<sup>9</sup>Three of these agencies had received an unqualified opinion on their originally issued fiscal year 2004 financial statements while the remaining four had received a disclaimer of opinion on their financial statements. The auditor for one of the agencies withdrew the unqualified opinion that had been previously rendered on the agency's fiscal year 2004 financial statements and issued a qualified opinion on the restated financial statements.

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procedures to prevent or detect future similar errors.<sup>10</sup> Generally, the reasons for the restatements we reviewed were agencies' lack of effective internal controls over the processing and reporting of certain transactions and the failure of the auditors to design and/or perform adequate audit procedures to detect such errors. During our review, we noted that the extent of the restatements to the agencies' fiscal year 2003 financial statements varied from agency to agency, ranging from correcting two line items on an agency's balance sheet to correcting numerous line items on several of another agency's financial statements. In some cases, the net operating results of the agency were affected by the restatement. The amounts of the agencies' restatements ranged from several million dollars to more than \$91 billion.

Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. Material internal control weaknesses discussed in our fiscal year 2005 audit report serve to increase the risk that additional errors may occur and not be identified on a timely basis by agency management or their auditors, resulting in further restatements.

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<sup>10</sup>GAO, *Financial Audit: Restatements to the Department of State's Fiscal Year 2003 Financial Statements*, [GAO-05-814R](#) (Washington, D.C.: Sep. 20, 2005); GAO, *Financial Audit: Restatements to the Nuclear Regulatory Commission's Fiscal Year 2003 Financial Statements*, [GAO-06-30R](#) (Washington, D.C.: Oct. 27, 2005); GAO, *Financial Audit: Restatements to the General Services Administration's Fiscal Year 2003 Financial Statements*, [GAO-06-70R](#) (Washington, D.C.: Dec. 6, 2005); GAO *Financial Audit: Restatements to the National Science Foundation's Fiscal Year 2003 Financial Statements*, [GAO-06-229R](#) (Washington, D.C.: Dec. 22, 2005); and GAO, *Financial Audit: Restatements to the Department of Agriculture's Fiscal Year 2003 Financial Statements*, [GAO-06-254R](#) (Washington, D.C.: Jan. 26, 2006).

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## Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2005 and 2004

As has been the case for the previous eight fiscal years, the federal government did not maintain adequate systems or have sufficient reliable evidence to support certain material information reported in the U.S. government's consolidated financial statements. These material deficiencies, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's consolidated financial statements for the fiscal years ended September 30, 2005, and 2004 and also constitute material weaknesses in internal control.<sup>11</sup> Appendix I describes the material deficiencies in more detail and highlights the primary effects of these material weaknesses on the consolidated financial statements and on the management of federal government operations. These material deficiencies were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the 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 total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain federal agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government's consolidated financial statements were consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP; and
- resolve material differences that exist between the total net outlays reported in federal agencies' Statements of Budgetary Resources and the records used by Treasury to prepare the Statements of Changes in Cash Balance from Unified Budget and Other Activities.

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<sup>11</sup>We previously reported that material deficiencies prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2004.

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Due to the material deficiencies and additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the consolidated financial statements that have not been identified.

In addition to the material weaknesses that represented material deficiencies, which were discussed above, we found the following four other material weaknesses in internal control as of September 30, 2005. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the consolidated financial statements and on the management of federal government operations. These material weaknesses were the federal government's inability to

- implement effective processes and procedures for properly estimating the cost of certain lending programs, related loan guarantee liabilities, and value of direct loans;
- determine the extent to which improper payments exist;
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis; and
- effectively manage its tax collection activities.

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## Systems Problems at Agencies Continue to Hinder Accountability

For fiscal year 2005, 18 of 24 CFO Act agencies were able to attain unqualified opinions on their financial statements by the November 15, 2005, reporting deadline established by the Office of Management and Budget (OMB) (see app. III). The independent auditor of the Department of State subsequently withdrew its qualified opinion on the department's fiscal year 2005 financial statements and reissued an unqualified opinion on such financial statements dated December 14, 2005. As a result, 19 CFO Act agencies received unqualified opinions on their fiscal year 2005 financial statements. However, irrespective of these unqualified opinions, many agencies do not have timely, reliable, and useful financial information and effective controls with which to make informed decisions and ensure accountability on an ongoing basis. The ability to produce the data needed for efficient and effective management of day-to-day operations in the federal government and provide the necessary accountability to taxpayers and the Congress has been a long-standing challenge at most federal agencies.

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The results of the fiscal year 2005 Federal Financial Managers Integrity Act of 1996 (FFMIA) assessments performed by agency inspectors general or their contract auditors show that certain problems continue to affect financial management systems at most CFO Act agencies. These problems include nonintegrated financial systems, lack of accurate and timely recording of data, inadequate reconciliation procedures, and noncompliance with accounting standards and the U.S. Government Standard General Ledger (SGL).<sup>12</sup> While the problems are much more severe at some agencies than at others, the nature and severity of the problems indicate that overall, management at most CFO Act agencies lack the complete range of information needed for accountability, performance reporting, and decision making.

FFMIA requires auditors, as part of the CFO Act agencies' financial statement audits, to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the SGL at the transaction level. The major barrier to achieving compliance with FFMIA continues to be the inability of agencies to meet federal financial management systems requirements, which involve not only core financial systems, but also administrative and programmatic systems.

For fiscal year 2005, auditors for 18 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more of the FFMIA requirements noted above. For 5 of the remaining 6 CFO Act agencies, auditors provided negative assurance, meaning that nothing came to their attention indicating that the agencies' financial management systems did not substantially meet FFMIA requirements. The auditors for these 5 agencies did not definitively state whether the agencies' systems substantially complied with FFMIA requirements, as is required under the statute. In contrast, auditors for the Department of Labor provided positive assurance by stating that, in their opinion, the department's financial management systems substantially complied with the requirements of FFMIA. Further, auditors for the Department of Energy and the General Services Administration reported that those agencies' financial management systems did not substantially comply with FFMIA requirements in fiscal year 2005 due to recently

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<sup>12</sup>The United States Standard General Ledger provides a uniform Chart of Accounts and technical guidance to be used in standardizing federal agency accounting.

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identified internal control weaknesses over financial reporting. The auditors had not reported any FFMIA compliance issues at those 2 federal agencies in fiscal year 2004.

As individual agencies move forward with various initiatives to address FFMIA-related problems, it is important that consideration be given to the numerous governmentwide initiatives under way to address long-standing financial management weaknesses. OMB continues to move forward on new initiatives to enhance financial management and provide results-oriented information in the federal government. Two ongoing developments in this area in fiscal year 2005 were the realignment of responsibilities formerly performed by the Joint Financial Management Improvement Program and its Program Management Office and the development of financial management lines of business. The overall vision of these initiatives is to eliminate duplicative roles, streamline financial management improvement efforts, and improve the cost, quality, and performance of financial management systems by leveraging shared services<sup>13</sup> solutions.

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## Addressing Major Impediments to an Opinion on Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's consolidated financial statements continued to be: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Extensive cooperative efforts between agency chief financial officers, inspectors general, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's consolidated financial statements.

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## Financial Management at DOD

Essential to improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated

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<sup>13</sup>As defined by the Association of Government Accountants (AGA), shared services represent "financial and administrative services provided by a single organization established to provide such services efficiently and effectively for the benefit of multiple organizations or entities". See AGA Corporate Partner Advisory Group Research, *Financial Management Shared Services: A Guide for Federal Users*, AGA CPAG Research Series: Report No. 2, July 2005.



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financial statements is the resolution of serious weaknesses in DOD's business operations. DOD's financial management weaknesses are pervasive, complex, long standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or major DOD components has passed the test of an independent financial audit<sup>14</sup> because of pervasive weaknesses in business management systems, processes, and internal control. Of the 25 areas on GAO's governmentwide high-risk list, 8 are DOD programs or operations, and the department shares responsibility for 6 other high-risk areas that are governmentwide in scope.<sup>15</sup> These weaknesses adversely affect the department's (and the federal government's) ability to control costs; ensure basic accountability; anticipate future costs and claims on the budget; measure performance; maintain funds control; prevent fraud, waste, and abuse; and address pressing management issues.

Effective management, reporting, and decision making depend upon information that is timely, reliable, and useful. Recent actions taken by the department to develop an integrated strategy to better understand and initiate efforts to systematically transform and address weaknesses in its business operations are encouraging. On September 28, 2005, DOD approved two key components of its transformation strategy: the Business Enterprise Architecture and the Business Transition Plan.<sup>16</sup> An enterprise architecture should provide a clear and comprehensive picture of an entity, whether it is an organization (e.g., a federal department) or a functional or mission area that cuts across more than one organization (e.g., financial management). This picture consists of snapshots of both the enterprise's current "As Is" operational and technological environment

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<sup>14</sup>Although not major DOD components, the Military Retirement Fund received an unqualified audit opinion on its fiscal year 2005 financial statements, and the DOD Medicare Eligible Retiree Health Care Fund received a qualified audit opinion on its fiscal year 2005 financial statements.

<sup>15</sup>GAO, *High-Risk Series: An Update*, [GAO-05-207](#) (Washington, D.C.: January 2005). The eight specific DOD high-risk areas are: (1) approach to business transformation, (2) business systems modernization, (3) contract management, (4) financial management, (5) personnel security clearance program, (6) supply chain management, (7) support infrastructure management, and (8) weapon systems acquisition. The six governmentwide high-risk areas are (1) disability programs, (2) interagency contracting, (3) information systems and critical infrastructure, (4) information sharing for homeland security, (5) human capital, and (6) real property.

<sup>16</sup>The Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005, Pub. L. No. 108-375, §332, 118 Stat. 1811, 1851-1856 (Oct. 28, 2004) (codified, in part, at 10 U.S.C. §2222) required DOD to develop a Business Enterprise Architecture and Transition Plan.

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and its target or “To Be” environment. A transition plan should provide the capital investment roadmap for transitioning from the current to the target environment by describing how and when new business systems will be developed and implemented. In November 2005, we reported<sup>17</sup> that while DOD had made important progress toward building a foundation upon which to improve its business operations, it did not fully satisfy the requirements of the Ronald W. Reagan National Defense Authorization Act for 2005.<sup>18</sup> For example, we reported that the architecture did not address how DOD would comply with federal accounting, financial, and reporting requirements, such as the United States Government Standard General Ledger.

In late December 2005, DOD issued its Financial Improvement and Audit Readiness (FIAR) Plan, a third major component of its business transformation strategy. According to DOD briefings, the “purpose of the FIAR Plan is to provide a roadmap to guide the department in improving financial management and achieving a clean audit opinion.” Similar to an earlier DOD improvement effort, the Financial Improvement Initiative, the FIAR Plan utilizes an incremental approach to structure its process for examining its operations, diagnosing problems, planning corrective actions, and preparing for audit. However, unlike the previous plan, the FIAR Plan does not establish an overall goal of achieving a clean audit opinion on its departmentwide financial statements by a specific date. Rather, the FIAR Plan appears to recognize that it will take several years before DOD is able to implement the systems, processes, and other changes necessary to fully address its financial management weaknesses. In the interim, DOD plans to focus its initial efforts on four areas: (1) military equipment, (2) real property, (3) military retiree eligible health care fund liabilities, and (4) environmental liabilities. The FIAR Plan also focuses on the U.S. Marine Corps and the U.S. Army Corps of Engineers, Civil Works because these organizations intend to be ready for audit in fiscal years 2007 and 2008, respectively. As the FIAR Plan evolves, DOD intends to refine or include additional goals to improve processes and systems related to other balance sheet line items and financial statements.

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<sup>17</sup>GAO, *DOD Business Systems Modernization: Important Progress Made in Establishing Foundational Architecture Products and Investment Management Practices, but Much Work Remains*, [GAO-06-219](#) (Washington, D.C.: Nov. 23, 2005).

<sup>18</sup>Pub. L. No. 108-375, §332, 118 Stat. 1811, 1851 (Oct. 28, 2004).

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There will need to be ongoing and sustained top management attention to business transformation at DOD to address what are some of the most difficult financial management challenges in the federal government. As we noted in our November 2005 testimony,<sup>19</sup> we continue to believe that the implementation of a new Chief Management Officer position at DOD will be needed in order for the department to succeed in its overall business transformation strategy. We will continue to monitor DOD's efforts to transform its business operations and address its financial management deficiencies as part of our continuing DOD business enterprise architecture work and our oversight of DOD's financial statement audit.

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## Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the CFOs of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners.<sup>20</sup> In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2005 and 2004. For fiscal year 2005, based on trading partner information provided in the Governmentwide Financial Reporting System discussed below, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the fiscal year 2005 "Material Difference Reports", we noted a significant number of CFOs were still unable to explain their material differences with their trading partners. For both fiscal years 2005 and 2004, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts

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<sup>19</sup>GAO, *Defense Management: Foundational Steps Being Taken to Manage DOD Business Systems Modernization, but Much Remains to be Accomplished to Effect True Business Transformation*, [GAO-06-234T](#) (Washington, D.C.: Nov. 9, 2005).

<sup>20</sup>Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

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reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

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## Preparing the Consolidated Financial Statements

The federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP. During fiscal year 2005, Treasury continued the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements. The goal of GFRS is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support, and to resolve many of the weaknesses we have identified in the process for preparing the consolidated financial statements. For the fiscal year 2005 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, but GFRS was still not at the stage that it could be used to fully compile the consolidated financial statements from the information captured. Treasury did, however, make progress in demonstrating that amounts in the consolidated Balance Sheet and Statement of Net Cost were consistent with federal agencies' audited financial statements prior to eliminating intragovernmental activity and balances.

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## Closing Comments

In closing, given the federal government's overall financial condition and long-term fiscal imbalance, the need for the Congress and the President to have timely, reliable, and useful financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are made more difficult without such information. Until the problems discussed in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers. It will also be key that the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving these problems and that they support improvement efforts.

Addressing the nation's long-term fiscal imbalance constitutes a major transformational challenge that may take a generation or more to resolve.

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Given the size of the projected deficit, the U.S. government will not be able to grow its way out of this problem—tough choices will be required.

Traditional incremental approaches to budgeting will need to give way to more fundamental and periodic reexaminations of the base of government. Our report, *21st Century Challenges: Reexamining the Base of the Federal Government*,<sup>21</sup> is intended to support the Congress in identifying issues and options that could help address these fiscal pressures.

Further, the Congress needs to have access to the long-term cost of selected spending and tax proposals before they enact related laws. The fiscal risks previously mentioned can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the federal government. New reporting approaches, as well as enhanced budget processes and control mechanisms, are needed to better understand, monitor, and manage the impact of spending and tax policies over the long term. In addition, a set of key national, outcome-based performance metrics would inform strategic planning, enhance performance and accountability reporting, and help to assess the impact of various spending programs and tax policies.

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

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## GAO Contacts

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600.

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<sup>21</sup>GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, [GAO-05-325SP](#) (Washington, D.C.: February 2005).

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# Appendix I: Material Deficiencies

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## Material Deficiencies

The continuing material deficiencies discussed below contributed to our disclaimer of opinion on the federal government's consolidated financial statements for fiscal years 2005 and 2004. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the consolidated financial statements, as described below.

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## 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 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 agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (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.

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## 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 those related to treaties and other international agreements entered into to further the U.S. 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, improperly stated environmental and disposal liabilities

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and weak internal control supporting the process for their estimation 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, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

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### Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies 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 related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2005 and 2004, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and the Department of the Treasury's records of disbursements and unsupported federal agency 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. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.

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### Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies 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 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners.<sup>1</sup> In addition, these agencies are required to report to Treasury,

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<sup>1</sup>Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

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the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2005 and 2004. For these fiscal years, based on trading partner information provided in the Governmentwide Financial Reporting System (GFRS), Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the "Material Difference Reports" for fiscal year 2005, we noted a significant number of CFOs were still unable to explain the differences with their trading partners. For both fiscal years 2005 and 2004, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, about 25 percent of the significant federal agencies reported internal control weaknesses regarding reconciliations of intragovernmental activity and balances. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired.

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## Preparation of Consolidated Financial Statements

Fiscal year 2005 was the second year that Treasury used its GFRS to collect agency financial statement information taken directly from federal agencies' audited financial statements. The goal of GFRS is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the U.S. government's consolidated financial statements and resolve many of the weaknesses we previously identified in the process for preparing the consolidated financial statements. For both the fiscal year 2005 and 2004 reporting processes, GFRS was able to capture agency financial information, but GFRS was still not at the stage that it could be used to fully compile the consolidated financial statements from the information captured. Therefore, for fiscal year 2005 Treasury continued to primarily use manual procedures to prepare the consolidated financial statements. As discussed in the scope limitations section of our audit report, Treasury could not produce the fiscal year 2005 consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures. In addition, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S.



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generally accepted accounting principles (GAAP). Specifically, during our fiscal year 2005 audit, we found the following<sup>2</sup>

- Treasury’s process for compiling the consolidated financial statements did not ensure that the information in all of the five principal financial statements and notes was fully consistent with the underlying information in federal agencies’ audited financial statements and other financial data. Treasury made progress in demonstrating amounts in the Balance Sheet and the Statement of Net Cost were consistent with federal agencies’ audited financial statements prior to eliminating intragovernmental activity and balances. However, about 25 percent of the significant federal agencies’ auditors reported internal control weaknesses related to the processes the agencies perform to provide financial statement information to Treasury for preparing the consolidated financial statements.
- To make the fiscal years 2005 and 2004 consolidated financial statements balance, Treasury recorded a net \$4.3 billion decrease and a net \$3.4 billion increase, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled “Unreconciled Transactions Affecting the Change in Net Position.”<sup>3</sup> An additional net \$3.2 billion and \$1.2 billion of unreconciled transactions were recorded in the Statement of Net Cost for fiscal years 2005 and 2004, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2005 showed a net operating cost of \$760 billion, to the budget results, which for the same period showed a unified budget deficit of \$318.5 billion. In addition, a net \$13.2 billion “net amount of all other differences” was needed to force this statement into balance.

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<sup>2</sup>Most of the issues we identified in fiscal year 2005 existed in fiscal year 2004, and many have existed for a number of years. In May 2005, we reported in greater detail on the issues we identified in GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Continues to Need Improvement*, [GAO-05-407](#) (Washington, D.C.: May 4, 2005). This report includes numerous recommendations to Treasury and OMB.

<sup>3</sup>Although Treasury was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the consolidated financial statements.

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- Treasury's ability to eliminate certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As discussed above, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance, resulting in the need for unsupported intragovernmental elimination entries in order to force the Statement of Operations and Changes in Net Position into balance. In addition, significant differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled and still remain unresolved. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the consolidated financial statements.
  - Treasury lacked a process to ensure that fiscal years 2005 and 2004 consolidated financial statements and notes were comparable. Certain information reported for fiscal 2004 may require reclassification to be comparable to the fiscal year 2005 amounts. However, Treasury did not analyze this information or reclassify amounts within various financial statement line items and notes to enhance comparability. For example, the Reconciliations of Net Operating Cost and Unified Budget Deficit showed \$47.8 billion and \$.2 billion for property, plant, and equipment disposals and revaluations for fiscal years 2005 and 2004, respectively. However, based on the financial information provided by agencies to Treasury in GFRS, the fiscal year 2004 amount would be \$25.4 billion. The difference would be reclassified from the net amount of all other differences line item on the Reconciliations of Net Operating Cost and Unified Budget Deficit.
  - Treasury did not have an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. For example, we found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury submitted a proposal to the Federal Accounting Standards Advisory Board (FASAB) seeking to amend previously issued standards and eliminate or lessen the disclosure requirements for the consolidated financial statements so that GAAP would no longer require certain of the information that Treasury has not been reporting. Comments are due to the FASAB today, on an exposure draft of a proposed FASAB standard, based on the Treasury proposal. Treasury stated that it is waiting for FASAB approval and issuance of this proposed standard to determine the disclosures that will be required in future consolidated financial statements. As a result of Treasury not providing us with adequate documentation of its rationale for excluding the currently required information and certain of the material

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deficiencies noted above, we were unable again to determine if the missing information was material to the consolidated financial statements.

- Information system weaknesses existed within the segments of GFRS that were used during the fiscal years 2005 and 2004 reporting processes. We found that the GFRS database (1) was not configured to prevent the alteration of data submitted by federal agencies and (2) was used for both production and testing during the reporting processes. Therefore, information submitted by federal agencies within GFRS is not adequately protected against unauthorized modification or loss. In addition, Treasury was unable to explain why numerous GFRS users appeared to have inappropriate access to GFRS agency information or demonstrate the appropriate segregation of duties exist.
- Although Treasury made progress in addressing them, certain other internal control weaknesses in its process for preparing the consolidated financial statements continued to exist and involved a lack of (1) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (2) adequate supporting documentation for certain adjustments made to the consolidated financial statements, and (3) necessary management reviews.
- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, there are undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.
- Treasury did not have the infrastructure to address the magnitude of the fiscal year 2005 financial reporting challenges it was faced with, such as an incomplete financial reporting system, compressed time frames for compiling the financial information, and lack of adequate internal control over the financial statement preparation process. 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 ensure reliable financial reporting by the reporting date.
- Treasury, in coordination with OMB, had not provided us with adequate documentation evidencing an executable plan of action and milestones for short-term and long-range solutions for certain internal control

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weaknesses we have previously reported regarding the process for preparing the consolidated financial statements.

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## Net Outlays-A Component of the Budget Deficit

OMB Circular A-136, *Financial Reporting Requirements*, which incorporated and updated OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, states that outlays in federal agencies' Statement of Budgetary Resources (SBR) should agree with the net outlays reported in the *Budget of the United States Government*. In addition, Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including net outlays) in the financial statements and the amounts described as "actual" in the *Budget of the United States Government*.

The federal government reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance) and the Reconciliations of Net Operating Cost and Unified Budget Deficit (Reconciliation Statement) budget deficits for fiscal years 2005 and 2004 of \$318.5 billion and \$412.3 billion, respectively. The budget deficit is calculated by subtracting actual budget outlays from actual budget receipts.<sup>4</sup> As we have reported since fiscal year 2003, we found material unreconciled differences between the total net outlays reported in selected federal agencies' SBRs and Treasury's central accounting records, which it uses to prepare the Statement of Changes in Cash Balance. Treasury's processes for preparing the Statement of Changes in Cash Balance do not include procedures for identifying and resolving differences between its central accounting records and net outlay amounts reported in agencies' SBRs.

In fiscal year 2004, we noted reported internal control weaknesses regarding certain agencies' SBRs. In fiscal year 2005, several agencies'

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<sup>4</sup>In previous years, the Statement of Changes in Cash Balance reported actual budget outlays and actual budget receipts; however, beginning in fiscal year 2004, the federal government chose not to disclose budget outlays and budget receipts in this financial statement and only included the budget deficit. Receipts and net outlays (unified budget amounts) are also reported in governmentwide reports—specifically, in the President's Budget (annually); Treasury's *Final Monthly Treasury Statement*, as part of leading economic indicators on federal finances (quarterly); and Treasury's annual *Combined Statement of Receipts, Outlays, and Balances of the United States Government*.

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auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses transcend to agencies' ability to also report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its *Combined Statement of Receipts, Outlays, and Balances*,<sup>5</sup> and certain amounts reported in the Budget of the United States Government.

OMB has been working with agencies to reduce the differences between the total net outlays reported in the federal agencies' SBRs and the Statement of Changes in Cash Balance. In June 2005, OMB issued its *Differences Between FY 2004 Budget Execution Reports and Financial Statements for CFO Act Agencies* report which discusses various types of differences in federal agency financial statements and budget execution reports, including net outlays, and makes recommendations for OMB and federal agencies to consider in improving both sets of reports in the future.

Until the material differences between the total net outlays reported in the federal agencies' SBRs and the records used to prepare the Statement of Changes in Cash Balance are timely reconciled, the effect of these differences on the U.S. government's consolidated financial statements will be unknown.

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<sup>5</sup>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 agency reporting.

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# Appendix II: Other Material Weaknesses

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**Other Material Weaknesses** The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2005. In addition to the material deficiencies discussed in appendix I, we found the following four other material weaknesses in internal control.

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**Loans Receivable and Loan Guarantee Liabilities** Federal agencies continue to have material weaknesses and reportable conditions related to their lending activities. The Department of Housing and Urban Development lacked adequate management reviews of underlying data and cost estimation methodologies that resulted in material errors being undetected, and significant adjustments were needed. In addition, the Department of Education's processes do not provide for a robust budget-to-actual cost comparison or facilitate assessments of the validity of its lending program cost estimates. While the Small Business Administration made substantial progress to improve its cost-estimation processes, additional improvements are still needed to ensure that year-end reporting is accurate. These deficiencies plus others at the Department of Agriculture relating to the processes and procedures for estimating program costs continue to 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. Further, these weaknesses and the complexities associated with estimating the costs of lending activities greatly increase the risk that significant errors in agency and governmentwide financial statements could occur and go undetected.

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**Improper Payments** While agencies have made progress in implementing processes and controls to identify, estimate, and reduce improper payments,<sup>1</sup> such improper payments are a long-standing, widespread, and significant problem in the federal government. The Congress acknowledged this problem by passing the Improper Payment Information Act of 2002 (IPIA).<sup>2</sup> The IPIA requires agencies to review all programs and activities, identify

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<sup>1</sup>Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.

<sup>2</sup>Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

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those that may be susceptible to significant improper payments,<sup>3</sup> estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments. Further, in fiscal year 2005, the Office of Management and Budget (OMB) began to separately track the elimination of improper payments under the President's Management Agenda.

Significant challenges remain to effectively achieve the goals of the IPIA. From our review of agencies' fiscal year 2005 Performance and Accountability Reports (PARs), we noted that some agencies still have not instituted a systematic method of reviewing all programs and activities, have not identified all programs susceptible to significant improper payments, and/or have not annually estimated improper payments for their high-risk programs. For example, seven major agency programs with outlays totaling about \$280 billion, including Medicaid and the Temporary Assistance For Needy Families programs, still cannot annually estimate improper payments, even though they were required by OMB to report such information beginning with their fiscal year 2003 budget submissions. In addition, two agency auditors that tested compliance with IPIA cited agency noncompliance with the act in their annual audit reports.

Federal agencies' estimates of improper payments, based on available information, for fiscal year 2005 exceeded \$38 billion, a net decrease of about \$7 billion, or 16 percent, from the prior year improper payment estimate of \$45 billion.<sup>4</sup> This decrease was attributable to the following factors. In fiscal year 2005, the Department of Health and Human Services reported a \$9.6 billion decrease in its Medicare program improper payment estimate, principally due to improvements in its due diligence with providers to ensure the necessary documentation is in place to support payment claims. However, in fiscal year 2005, this decrease was partially offset as a result of more programs reporting estimates of improper payments.

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<sup>3</sup>OMB defines the term "significant improper payments" as "annual erroneous payments in the program exceeding both 2.5 percent of program payments and \$10 million."

<sup>4</sup>In their fiscal year 2005 PARs, selected agencies updated their fiscal year 2004 improper payment estimates to reflect changes since issuance of their fiscal year 2004 PARs. These updates increased the governmentwide improper payment estimate for fiscal year 2004 from \$45 billion to \$46 billion.

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## Information Security

Although progress has been made, serious and widespread information security control weaknesses 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. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced with hearings on Federal Information Security Management Act of 2002<sup>5</sup> implementation and information security. In addition, the administration has taken important actions to improve information security, such as revising agency internal control requirements in OMB Circular A-123<sup>6</sup> and issuing extensive guidance on information security.

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## Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities,<sup>7</sup> an issue that has been reported in our financial statement audit reports for the past 8 years. Due to errors and delays in recording taxpayer information, payments, and other activities, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

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<sup>5</sup>Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).

<sup>6</sup>OMB Circular No. A-123, *Management's Responsibility for Internal Control* (Revised December 21, 2004).

<sup>7</sup>GAO, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements*, [GAO-06-137](#) (Washington, D.C.: Nov. 10, 2005).



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Weaknesses in controls over tax collection activities continue to affect the federal government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting of revenues affect the federal government's ability to make informed decisions about collection efforts. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

# Appendix III: Fiscal Year 2005 Audit Results

**Table 2: CFO Act Agencies: Fiscal Year 2005 Audit Results, Principal Auditors, and Number of Other Audit Contractors**

<b>CFO Act agencies</b>	<b>Opinion rendered by agency auditor</b>	<b>Agencies' auditors reported material weaknesses or noncompliance</b>	<b>Principal auditor</b>	<b>Number of other audit contractors</b>
Agency for International Development	Unqualified	√	OIG	2
Agriculture	Unqualified	√	OIG	3
Commerce	Unqualified	√	KPMG LLP	0
Defense	Disclaimer	√	OIG	1
Education	Unqualified	√	Ernst & Young, LLP	0
Energy	Disclaimer	√	KPMG LLP	0
Environmental Protection Agency	Unqualified	√	OIG	0
General Services Administration	(a)	√	PricewaterhouseCoopers LLP	0
Health and Human Services	Unqualified	√	Ernst & Young, LLP	2
Homeland Security	Disclaimer	√	KPMG LLP	0
Housing and Urban Development	Unqualified	√	OIG	1
Interior	Unqualified	√	KPMG LLP	0
Justice	Unqualified	√	KPMG LLP	2
Labor	Unqualified		R. Navarro & Associates, Inc.	1
National Aeronautics and Space Administration	Disclaimer	√	Ernst & Young, LLP	0
National Science Foundation	Unqualified		KPMG LLP	0
Nuclear Regulatory Commission	Unqualified	√	R. Navarro & Associates, Inc.	0
Office of Personnel Management	Unqualified	√	KPMG LLP	0
Small Business Administration	Unqualified	√	Cotton and Company LLP	0
Social Security Administration	Unqualified		PricewaterhouseCoopers LLP	2
State	(b)	√	Leonard G. Birnbaum and Company, LLP	4
Transportation	Unqualified	√	OIG	3
Treasury	Unqualified	√	KPMG LLP	5
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP	0

Source: GAO.

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<sup>a</sup>In 2005, GSA received an unqualified opinion on its Balance Sheet, Statement of Changes in Net Position, and Statement of Net Cost, and a disclaimer of opinion on its Statement of Budgetary Resources and Statement of Financing.

<sup>b</sup>The independent auditors of the Department of State's fiscal year 2005 financial statements issued a qualified opinion because they were not able to examine evidence regarding personal property in time to meet the November 15, 2005, reporting deadline. In late December, GAO was informed by the Acting Chief Financial Officer for the Department of State that subsequent to the issuance of the qualified opinion, the independent auditors satisfied themselves about the amounts presented as personal property. As a result, the auditors issued an unqualified opinion on the Department of State's fiscal year 2005 financial statements dated December 14, 2005.

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