

Report of Independent Auditors

To the Secretary of the Department of Health of Human Services and the Inspector General of the Department of Health and Human Services

We have audited the accompanying consolidated balance sheets of the Department of Health and Human Services (HHS) as of September 30, 2007 and 2006, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources for the years then ended, and the statements of social insurance as of January 1, 2007 and 2006. These financial statements are the responsibility of HHS's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of HHS as of September 30, 2007 and 2006, and its net cost of operations, changes in net position and budgetary resources for the years then ended, and its social insurance program as of January 1, 2007 and 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the financial statements, the Office of Management and Budget has exempted HHS from certain requirements of OMB Circular No. A-11, *Preparation, Submission and Execution of the Budget*. Specifically, for the Medicare program, HHS is exempted from reporting refunds of prior year obligations separately from refunds of current year obligations on the SF-133. OMB has mandated that HHS report all Medicare cash collections as an offsetting receipt.

As discussed in Note 27 to the financial statements, the statements of social insurance present the actuarial present value of the Hospital Insurance (HI) and Supplementary Medical

Insurance (SMI) trust funds' estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program. In preparing the statements of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statements. However, because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material. In addition to the inherent variability that underlies the expenditure projections prepared for all parts of Medicare, the SMI Part D projections have an added uncertainty in that they were prepared using very little program data upon which to base the estimates.

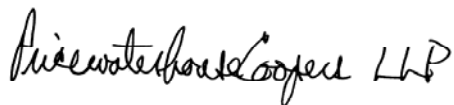
As discussed in Note 28 to the financial statements, the projected SMI Part B expenditure growth reflected in the statement of social insurance as of January 1, 2007 (the "2007 SOSI") is likely understated due to the structure of physician payment updates, which under current law would result in multiple years of significant reductions in physician payments, totalling an estimated 41 percent over the next nine years. Since these reductions are required in the future under the current-law payment system, they are reflected in the 2007 SOSI as required under generally accepted accounting principles. However, in practice it is not possible to anticipate what actions Congress might take, either in the near or long term, to alter the physician payment updates. For example, Congress has overridden scheduled reductions in physician payments for each of the last five years. The potential magnitude of the understatement of Part B expenditures, due to the physician payment updates can differ materially from the amount presented in the 2007 SOSI. In Note 28, management has illustrated the potential effects using two hypothetical examples of changes to current law. Under current law and as presented in the 2007 SOSI, the projected 75-year present value of future Part B expenditures is \$18.2 trillion. In management's hypothetical examples, if Congress were to set future physician payment updates at zero percent per year, then, absent other provisions to offset these costs, the projected present value would increase to \$22.6 trillion. Alternatively, if Congress were to set future physician payment updates equal to the Medicare Economic Index (projected to be 2 to 2.5 percent per year), the present value would be \$25.4 trillion. Management's hypothetical examples have not been audited, and accordingly, we express no opinion on them.

The Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI) and Required Supplementary Information (RSI) are not a required part of the financial statements but are supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A, RSSI and RSI. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the consolidated and combined financial statements of HHS taken as a whole. The additional information presented on the statements of social insurance as of January 1, 2007 and 2006, is presented for purposes of additional analysis and is not a required part of the consolidated or combined financial statements. Such information has been subjected to the auditing procedures applied in the audit of the consolidated and combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated and combined financial statements taken as a whole.

The other accompanying information is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the consolidated and combined financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued reports dated November 14, 2007 on our consideration of HHS's internal control and a report dated November 14, 2007 on its compliance and other matters for the year ended September 30, 2007. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.



November 14, 2007