



**Comptroller General  
of the United States**

**United States Government Accountability Office  
Washington, DC 20548**

December 15, 2006

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

Our report on the U.S. government's consolidated financial statements for fiscal years 2006 and 2005 is enclosed. In summary, we found the following:

- Certain material weaknesses in financial reporting<sup>1</sup> and other limitations on the scope of our work resulted in conditions that, for the 10th consecutive year, prevented us from expressing an opinion on the federal government's consolidated financial statements. About \$797 billion, or 53 percent, of the federal government's reported total assets as of September 30, 2006, and approximately \$790 billion, or 27 percent, of the federal government's reported net cost for fiscal year 2006 relate to 5 of the 24 Chief Financial Officers (CFO) Act agencies' fiscal year 2006 financial statements that were disclaimed on or not audited.<sup>2</sup>
- 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, 2006.
- Our work to test compliance with selected provisions of significant laws and regulations in fiscal year 2006 was limited by the material weaknesses and scope limitations discussed in our report.

While over the past 10 years significant progress has been made in improving federal financial management since the U.S. government began preparing consolidated financial statements, three major impediments continue to prevent us from rendering an opinion on

---

<sup>1</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.

<sup>2</sup>The CFO Act agencies that received disclaimers of opinions on all of their fiscal year 2006 financial statements were the Department of Defense, Department of State, and the National Aeronautics and Space Administration. For the Department of Homeland Security for fiscal year 2006, only the Consolidated Balance Sheet and Statement of Custodial Activity were subjected to audit; the auditor was unable to express an opinion on these two financial statements. For fiscal year 2006, only the Consolidated Balance Sheet of the Department of Energy was subjected to audit, and the auditor qualified its opinion on this statement.

the consolidated financial statements: (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. Until the problems outlined in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

Accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations and fiscal condition. Beginning in fiscal year 2006, the Statement of Social Insurance, which shows long-range actuarial projections of scheduled social insurance benefits in excess of earmarked revenues, became a principal financial statement.<sup>3</sup> This new statement shows projected scheduled benefits exceeding earmarked revenues by approximately \$39<sup>4</sup> trillion in present value terms for the next 75-year period.<sup>5</sup> Considering this long-range projected funding gap in social insurance, in addition to reported liabilities (e.g., debt held by the public and federal employee and veterans benefits payable) and other implicit commitments and contingencies that the federal government has pledged to support, the federal government's fiscal exposures totaled approximately \$50 trillion as of September 30, 2006, an increase of about \$4 trillion over September 30, 2005, and up from about \$20 trillion as of September 30, 2000.<sup>6</sup> This translates into a current burden of about \$170,000 per American or approximately \$440,000 per American household. Also, beginning in fiscal year 2006, the consolidated financial statements reported earmarked funds activity separately from non earmarked funds activity.<sup>7</sup> For fiscal year 2006, earmarked funds revenue and non earmarked funds revenue totaled about \$1,094 billion and \$1,532 billion respectively. In addition, for fiscal year 2006, earmarked funds had reported net operating revenue of approximately \$172 billion and non earmarked funds reported net operating cost of approximately \$622 billion.<sup>8</sup>

---

<sup>3</sup>Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

<sup>4</sup>On an open group basis (current and future participants). On a closed group basis, which excludes the benefit payments and contributions of individuals under the age of 15 (or not yet born), this amount is approximately \$44 trillion.

<sup>5</sup>Black Lung's long-range actuarial projections are over a 34-year period.

<sup>6</sup>The federal government's fiscal exposures are derived from information reported throughout the financial statements and related footnotes.

<sup>7</sup>Earmarked funds (e.g., Social Security and Medicare trust funds) are financed by specifically identified revenues and other financing sources which remain available over time; are required by statute to be used for designated activities, benefits, or purposes; and must be accounted for separately from the federal government's general revenues. See the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards No. 27, *Identifying and Reporting Earmarked Funds* (Washington, D.C.: Dec. 28, 2004).

<sup>8</sup>The earmarked funds net operating revenue is the excess of revenues and of transfers from non earmarked funds over net costs. The non earmarked funds net operating cost is the excess of net costs and of transfers to earmarked funds over revenues.

Although improvements have been made, additional financial reporting enhancements are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. Specifically, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include a Statement of Fiscal Sustainability—providing a long-term look at the sustainability of social insurance in the context of all federal programs.<sup>9</sup> The reporting on fiscal sustainability should include additional information that will assist in understanding the sustainability of current social insurance and other federal programs, including key measures of fiscal sustainability and intergenerational equity,<sup>10</sup> projected annual cash flows, and changes in fiscal sustainability during the reporting period. Further, earmarked Social Security and Medicare taxes that have not yet been used to pay benefits should be recorded as deferred earmarked revenue, resulting in an additional liability for such social-insurance-related obligations.<sup>11</sup> As of September 30, 2006, such “unused” earmarked taxes related to social insurance totaled over \$2 trillion.

Finally, to better inform both Congress and American citizens about the federal government's fiscal condition and operations, the federal government should produce an easily understandable summary annual report that includes, in a clear, concise, and transparent manner, key financial and performance information embodied in the *Financial Report of the United States Government*. This report would include, among other things, illustrative graphs and charts depicting such information as (1) the cost of the federal government as a whole and for each major component such as defense and homeland security, (2) the primary components of federal revenues, and (3) various other current financial and future fiscal information.

- - - -

We appreciate the cooperation and assistance of the Department of the Treasury and Office of Management and Budget officials, as well as the federal agencies' CFO's and inspectors general, in carrying out our statutory responsibility to report on the U.S. government's consolidated financial statements. We look forward to continuing to work with these officials and the Congress to achieve the goals and objectives of financial management reform.

---

<sup>9</sup>The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

<sup>10</sup>Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

<sup>11</sup>The FASAB recently issued the preliminary views document, *Accounting for Social Insurance, Revised* (Washington, D.C.: Oct. 23, 2006), which discusses differing views on accounting for social insurance.

Our audit report begins on page 149. Our guide<sup>12</sup> to the *Financial Report of the United States Government* will help those who seek to obtain a better understanding of the Financial Report. In addition, our recently issued guide<sup>13</sup> on *Understanding Similarities and Differences between Accrual and Cash Deficits* provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time. These guides and other GAO reports noted above are available on GAO's Web site at [www.gao.gov](http://www.gao.gov).

Our report was prepared under the direction of Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-2600.

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

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

(198411)

---

<sup>12</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>13</sup>GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006).