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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

December 14, 2005

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 2005 and 2004 is enclosed. In summary, we found the following:

- Material deficiencies in financial reporting (which also represent material weaknesses[1]) and other limitations on the scope of our work resulted in conditions that, for the ninth consecutive year, prevented us from expressing an opinion on the federal government's consolidated financial statements. Auditors for 4 of the 24 Chief Financial Officers (CFO) Act agencies issued disclaimers of opinion on their agencies' fiscal year 2005 financial statements.[2] These agencies represent about $848 billion, or 58 percent, of the federal government's reported total assets as of September 30, 2005, and approximately $751 billion, or 25 percent, of the federal government's reported net cost for fiscal year 2005. Furthermore, several CFO Act agencies had to restate certain of their fiscal year 2004 financial statements.

- 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.

- Our work to determine compliance with selected provisions of significant laws and regulations in fiscal year 2005 was limited by the material weaknesses discussed in our report.

[1]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.
[2]The four agencies that received disclaimers of opinion on their fiscal year 2005 financial statements were the National Aeronautics and Space Administration, the Department of Defense, the Department of Energy, and the Department of Homeland Security (DHS). For fiscal year 2005, only DHS's consolidated balance sheet was subjected to audit. The auditor was unable to express an opinion on DHS's consolidated balance sheet as of September 30, 2005, and on the department's consolidated financial statements as of and for the year ended September 30, 2004.

Three major impediments to our ability to render 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. Moreover, as a result of the material deficiencies we found, readers are cautioned that amounts reported in the consolidated financial statements and related notes, certain information contained in the accompanying Management's Discussion and Analysis, and other financial management information that is taken from the same data sources as the consolidated financial statements, may not be reliable. 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, which are outlined in our report.

More troubling still, the federal government's financial condition and long-term fiscal outlook is continuing to deteriorate. 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, the federal government's accrual based net operating cost increased to $760 billion in fiscal year 2005 from $616 billion in fiscal year 2004. GAO's fiscal policy simulations illustrate that without significant changes on the spending and revenue sides of the budget, long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today's and tomorrow's commitments.

The current financial reporting model does not clearly 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[3] in the consolidated financial statements 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 (e.g., federal employee and veteran benefits payable), 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, up from about $20 trillion in 2000. This translates 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. These amounts do not include future costs resulting from Hurricane Katrina or the conflicts in Iraq and Afghanistan. Continuing on this unsustainable path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.

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

[3]The federal government's gross debt consists of debt held by the public and intragovernmental debt holdings.

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.[4] Enhanced reporting on tax expenditures would ensure greater transparency and accountability for revenue forgone by the federal government and provide a more cohesive picture of the federal government's policies and fiscal position.

Addressing the nation's long-term fiscal imbalance constitutes a major transformational challenge that may take a generation or more to resolve. 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 are required. Traditional incremental approaches to budgeting will need to give way to more fundamental and comprehensive reexaminations of the base of government. Our report, *21st Century Challenges: Reexamining the Base of the Federal Government*,[5] is intended to support the Congress in identifying issues and options that could help address these fiscal pressures. 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 outcome-based metrics would inform strategic planning, enhance performance and accountability reporting, and help to assess the impact of various spending programs and tax policies.

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We appreciate the cooperation and assistance of the Department of the Treasury and the Office of Management and Budget officials, as well as the federal agencies' chief financial officers 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.

Our audit report begins on page 135. We recently issued a guide[6] to the *Financial Report of the United States Government* to help those who seek to obtain a better understanding of the Financial Report. This guide and other GAO reports noted above are available on GAO's Web site at www.gao.gov.

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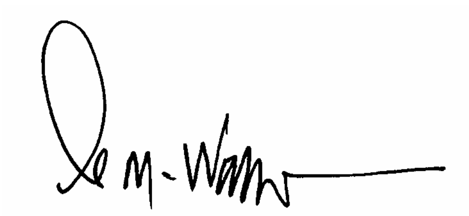
[4]The sum of individual tax expenditure estimates is useful for gauging the general magnitude of the revenue involved, but does not take into account possible interactions between individual provisions. For additional information, see GAO, *Government Performance and Accountability: Tax Expenditures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

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

[6]GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005).

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 at (202) 512-5500 or them at (202) 512-2600.



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

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