



United States Government Accountability Office
Washington, DC 20548

Independent Auditor's Report

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

The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, is required to annually submit audited financial statements for the U.S. government to the President and Congress. GAO is required to audit these statements.¹ This report includes (1) our report on the accompanying U.S. government's accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011; the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts and (2) our associated reports on internal control over financial reporting and on compliance with selected provisions of laws and regulations. As used in this report, accrual-based financial statements refer to all of the consolidated financial statements and notes, except for those related to the Statements of Social Insurance and the Statements of Changes in Social Insurance Amounts.²

Management of the federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP); (2) establishing, maintaining, and evaluating internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met;³ and (3) complying with laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies are responsible for implementing and maintaining financial management

¹The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331(e). The federal government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.

²The accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011, consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. The 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance, and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, including the related notes, are also included in the consolidated financial statements. Both the Statements of Social Insurance and the Statement of Changes in Social Insurance Amounts do not interrelate with the accrual-based consolidated financial statements.

³31 U.S.C. 3512 (c), (d) (commonly referred to as FMFIA). This act requires executive agency heads to evaluate and report annually to the President and Congress on the adequacy of their internal control and accounting systems and on actions to correct significant problems.

systems that substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).⁴ Appendix I discusses the objectives, scope, and methodology of our work.

In summary, we found the following:

- Certain material weaknesses⁵ in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that continued to prevent us from expressing an opinion on the accompanying accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011.⁶
- Significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, prevented us from expressing an opinion on those statements as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts. The Statements of Social Insurance for 2009 and 2008 are presented fairly, in all material respects, in conformity with U.S. GAAP.⁷
- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2012.
- Our tests of compliance with selected provisions of laws and regulations for fiscal year 2012 were limited by the material weaknesses and other scope limitations discussed in this report.

Significant Matters of Emphasis

Before discussing our conclusions on the consolidated financial statements, the following key items deserve emphasis in order to put the information contained in the consolidated financial statements and the Management's Discussion and Analysis section of the *2012 Financial Report of the United States Government (2012 Financial Report)* into context.

⁴FFMIA, which is reprinted in 31 U.S.C. 3512 note.

⁵A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

⁶We previously reported that certain material weaknesses prevented us from expressing an opinion on the accrual-based consolidated financial statements of the U.S. government for fiscal years 1997 through 2011. Also for these years, we previously reported that (1) material weaknesses resulted in ineffective internal control over financial reporting, and (2) our tests of compliance with selected provisions of laws and regulations were limited by material weaknesses and, for some years, other scope limitations.

⁷The valuation date is January 1 for all social insurance programs except the Black Lung program, which has a valuation date of September 30.

The Federal Government's Actions to Stabilize Financial Markets and to Promote Economic Recovery

The accrual-based consolidated financial statements for fiscal year 2012 include, as they did for fiscal year 2011, substantial assets and liabilities resulting from the federal government's actions to stabilize financial markets and to promote economic recovery. Key actions that the federal government has taken to stabilize financial markets and to promote economic recovery are discussed in the related Notes to the consolidated financial statements.

The ultimate cost of all of the federal government's market stabilization and economic recovery actions and the effect of such actions on its financial condition will not be known for some time. As of September 30, 2012, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in reported federal government assets of over \$152 billion (e.g., investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac),⁸ and the Troubled Asset Relief Program (TARP) equity investments)⁹ (reported net of about \$109 billion in valuation losses). In addition, the federal government reported incurring certain liabilities resulting from these actions. In valuing these and certain other assets and liabilities, management considered and selected assumptions and data that it believed provided a reasonable basis for the estimated values reported in the accrual-based consolidated financial statements. However, as discussed in Note 1 to the consolidated financial statements, there are many factors affecting these assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions. As such, there will be differences between the estimated values as of September 30, 2012, and the actual results, and such differences may be material. These differences will also affect the ultimate cost of the federal government's actions.

Long-Term Fiscal Challenges

Increased attention to risks that could affect the federal government's financial condition is made more important because of the nation's longer-term fiscal challenges. The comprehensive long-term fiscal projections presented in the unaudited Required Supplementary Information section of the *2012 Financial Report* show that—absent policy changes—the federal government continues to face an unsustainable fiscal path. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare benefits. Under these projections, spending for the major health and retirement programs will increase in coming decades as more members of the baby-boom generation become eligible for benefits and the health care cost for each enrollee increases. Over the long term, the structural imbalance between spending and revenue will lead to continued growth of debt held by the public as a share of gross domestic product (GDP); this means the current structure of the federal budget is unsustainable.

⁸The Housing and Economic Recovery Act of 2008 authorized the Department of the Treasury (Treasury) to purchase, until December 31, 2009, any amount of Fannie Mae or Freddie Mac securities, whether debt or equity. Pub. L. No. 110-289, § 1117, 112 Stat. 2654, 2683-88 (July 30, 2008).

⁹TARP was established by Treasury under authority provided in the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008). The act requires the U.S. Comptroller General to annually audit TARP's financial statements as well as report at least every 60 days on a variety of areas associated with oversight of TARP. To obtain copies of the TARP financial statement audits and the 60-day reports, see GAO's website at <http://www.gao.gov/docsearch/featured/financialmarketsandhousing.html>.

These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. If, however, the cost containment measures are not sustained over the long term—a concern expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow much more rapidly. GAO also prepares long-term federal fiscal simulations which continue to show debt rising as a share of GDP.¹⁰ Under GAO's Alternative simulation,¹¹ which uses the CMS Office of the Actuary's alternative health care cost projections, future spending in excess of receipts would be greater and debt held by the public as a share of GDP would grow more quickly than the projections in the *2012 Financial Report*.

In January 2013, the American Taxpayer Relief Act of 2012 was enacted,¹² which affected taxes and made some changes to the Budget Control Act of 2011.¹³ Congress will be considering further legislative changes to address the fiscal challenges.

Equity Interests in Certain Financial Organizations and Commercial Entities

As discussed in Note 1 to the consolidated financial statements, the financial statements do not include the assets, liabilities, or results of operations of any financial organizations or commercial entities in which the Department of the Treasury (Treasury) holds either a direct, indirect, or beneficial equity interest. Treasury and the Office of Management and Budget (OMB) have determined that none of these organizations or entities meet the criteria for a federal entity. The federal government's investments in and any liabilities to such organizations and entities, however, are valued and reported on the Balance Sheet.

Disclaimers of Opinion on the Accrual-Based Consolidated Financial Statements

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. government's accompanying accrual-based consolidated financial statements for fiscal years 2012 and 2011, principally resulting from limitations related to certain material weaknesses in internal control over financial reporting and other limitations on the scope of our work, we are unable to, and we do not, express an opinion on such accrual-based consolidated financial statements. As a result of these limitations, readers are cautioned that amounts reported in the accrual-based consolidated financial statements and related notes may not be reliable.

¹⁰GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2012 Update*, GAO-13-148SP (Washington, D.C.: Dec. 3, 2012).

¹¹GAO's Fall 2012 Alternative simulation incorporates the CMS Office of the Actuary's alternative projections for health care cost growth, which assume physician payments are not reduced as specified under current law and certain cost controls are not maintained over the long term. Also in this simulation, expiring tax provisions other than the Social Security payroll tax reductions are extended to 2022 and the alternative minimum tax exemption amount is indexed to inflation through 2022. In the Alternative simulation, discretionary spending follows the original discretionary spending caps set by the Budget Control Act of 2011, but not the lower caps triggered by the automatic enforcement procedures. Over the long term, discretionary spending and revenue are held at their historical average share of GDP.

¹²The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (Jan. 2, 2013).

¹³The Budget Control Act of 2011, Pub. L. No. 112-25, § 302, 125 Stat. 240, 256-59 (Aug. 2, 2011).

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the accompanying accrual-based consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. Specifically, these weaknesses concerned 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 accrual-based 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 reported total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain federal entities;
- adequately account for and reconcile intragovernmental activity and balances between federal entities;
- ensure that the federal government's accrual-based consolidated financial statements were (1) consistent with the underlying audited entities' financial statements, (2) properly balanced, and (3) in conformity with U.S. GAAP; and
- identify and either resolve or explain material differences between (1) certain components of the budget deficit reported in Treasury's records that are used to prepare the Reconciliation of Net Operating Cost and the Unified Budget Deficit, the Statement of Changes in Cash Balance from Unified Budget and Other Activities, and the Fiscal Projections for the U.S. Government (included in the unaudited Required Supplementary Information section of the *2012 Financial Report*) and (2) related amounts reported in federal entities' financial statements and underlying financial information and records.

These material weaknesses continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related 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 efficient and effective manner. Due to these material weaknesses and to other limitations on the scope of our work discussed below, additional issues may exist that could affect the accrual-based consolidated financial statements that were not identified. Appendix II describes these material weaknesses in more detail and highlights the primary effects of these material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

Disclaimers of Opinion on the Statements of Social Insurance for 2012, 2011, and 2010, and Unqualified Opinions for 2009 and 2008, and Disclaimers of Opinion on the Statements of Changes in Social Insurance Amounts for 2012 and 2011

Because of significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, we were unable to obtain sufficient evidence to support the amounts presented in the 2012, 2011, and 2010 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts. Consequently, we are unable to, and we do not, express opinions on the 2012, 2011, and 2010 Statements of Social Insurance as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts.

These significant uncertainties include the following.

- Medicare projections in the 2012, 2011, and 2010 Statements of Social Insurance were based on benefit formulas in current law and included a significant decrease in projected Medicare costs from the 2009 Statement of Social Insurance related to (1) reductions in Medicare payment rates for physician services (totaling almost 31 percent in January 2013, as estimated in the 2012 Medicare Trustees Report) and (2) productivity improvements for most other categories of Medicare providers, based on full implementation of the provisions of the Patient Protection and Affordable Care Act, as amended (PPACA).¹⁴ However, there are significant uncertainties concerning the achievement of these projected decreases in Medicare costs.
- Management has noted that actual future costs for Medicare are likely to exceed those shown by the current-law projections presented in the 2012, 2011, and 2010 Statements of Social Insurance due, for example, to the likelihood of modifications to the scheduled reductions in Medicare payment rates for physician services.¹⁵ The extent to which actual future costs exceed the projected current-law amounts due to changes to the scheduled reductions in Medicare payment rates for physician services and productivity adjustments depends on both the specific changes that might be legislated and whether such legislation would include further provisions to help offset such costs.
- Management has developed an illustrative alternative projection intended to provide additional context regarding the long-term sustainability of the Medicare program and to illustrate the uncertainties in the Statement of Social Insurance projections. The present value of future estimated expenditures in excess of future estimated revenue for Medicare, included in the illustrative alternative projection, exceeds the \$27.2 trillion estimate in the 2012 Statement of Social Insurance by \$10.1 trillion.

¹⁴PPACA, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

¹⁵Statutes have been enacted with provisions that prevented scheduled reductions in Medicare payment rates for physician services from taking effect from 2003 through 2013, including the most recent provision enacted in the American Taxpayer Relief Act of 2012. Some of these statutes also included provisions that reduced the federal government's spending on other categories of health care, which had the effect of helping to offset the increased costs related to the physician payment updates.

Projections of Medicare costs are sensitive to assumptions about future decisions by policymakers and about the behavioral responses of consumers, employers, and health care providers as policy, incentives, and the health care sector change over time. Such secondary impacts are not fully reflected in the Statement of Social Insurance projections but could be expected to influence the excess cost growth rate¹⁶ used in the projections. Key drivers of uncertainty about the excess cost growth rate include the future development and deployment of medical technology, the evolution of personal income, and the cost and availability of insurance, as well as federal policy changes, such as the implementation of PPACA. The work of the 2010 Medicare Technical Review Panel¹⁷ may provide additional guidance to management concerning ways to improve future Statement of Social Insurance projections and related disclosures.

As a result of the uncertainties discussed previously, readers are cautioned that amounts reported in the 2012, 2011, and 2010 Statements of Social Insurance and related Notes to such financial statements may not fairly present, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with U.S. GAAP. These uncertainties also affect the projected Medicare and Medicaid costs reported in the Fiscal Projections for the U.S. Government and Social Insurance information included in the unaudited Required Supplementary Information section of the *2012 Financial Report* and summarized in Management's Discussion and Analysis. The Required Supplementary Information section of the *2012 Financial Report* includes unaudited information concerning how changes in various assumptions would change the present value of future estimated expenditures in excess of future estimated revenue. As discussed in that section, Medicare projections are very sensitive to changes in the health care cost growth assumption.

In our opinion, the Statements of Social Insurance for 2009 and 2008 present fairly, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with U.S. GAAP.

The Statement of Social Insurance presents the actuarial present value of the federal government's estimated future revenue to be received from or on behalf of participants and estimated future expenditures to be paid to or on behalf of participants, based on benefit formulas in current law and using a projection period sufficient to illustrate the long-term sustainability of the social insurance programs.¹⁸ 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 statement. However, because of the large number of factors that affect the Statement of Social Insurance and the fact that such assumptions are

¹⁶The excess cost growth rate is the increase in health care spending per person relative to the growth of GDP per person after removing the effects of demographic changes on health care spending.

¹⁷In August 2010, the Secretary of Health and Human Services, working on behalf of the Board of Trustees, established an independent panel of expert actuaries and economists to review the assumptions and methods used by the Trustees to make projections of the financial status of the trust funds (commonly referred to as the 2010 Technical Review Panel on the Medicare Trustees Report). In December 2011, the panel members unanimously recommended a new approach that builds on certain long-standing assumptions while incorporating several key refinements. Based on the recommendations, the Medicare Trustees adopted new methods for projecting long-range Medicare costs in the 2012 Trustees Report. See section IV.D of the 2012 Medicare Trustees Report for details of the new methodology.

¹⁸The projection period used for the Social Security, Medicare, and Railroad Retirement social insurance programs is 75 years. For the Black Lung program, the projections are through September 30, 2040.

inherently subject to substantial uncertainty (arising from the likelihood of future events, significant uncertainties, and contingencies), 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 uncertainty that underlies the expenditure projections prepared for all parts of Medicare, the Supplementary Medical Insurance Part D projections have an added uncertainty in that they were prepared using very little program experience upon which to base the estimates.

The scheduled future benefits presented in the Statement of Social Insurance are based on benefit formulas in current law. However, consistent with the respective annual Trustees Reports, the Social Security and Medicare programs are not projected to be sustainable under current financing arrangements. Also, the law concerning these programs can be changed at any time. Payment of Social Security and Medicare Hospital Insurance (Part A) benefits is limited by law to the balances in the respective trust funds. Consequently, future scheduled benefits are limited to future revenues plus existing trust fund assets. As discussed in the unaudited Required Supplementary Information section of the *2012 Financial Report*, the Social Security and Medicare Hospital Insurance (Part A) trust funds are, based on achievement of the cost reductions discussed above, projected to be exhausted in 2033 and 2024, respectively, at which time they will be unable to pay the full amount of scheduled future benefits. For Social Security, as of January 1, 2012, future revenues were projected to be sufficient to pay 75 percent of scheduled benefits in 2033, the year of projected trust fund exhaustion, and decreasing to 73 percent of scheduled benefits in 2086. Similarly, for Medicare Hospital Insurance (Part A), as of January 1, 2012, future revenues were projected to be sufficient to pay 87 percent of scheduled benefits in 2024, the year of projected trust fund exhaustion, and then decreasing to 69 percent of scheduled benefits in 2086.

Other Limitations on the Scope of Our Work

For fiscal years 2012 and 2011, there were limitations on the scope of our work in addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. Treasury and OMB depend on representations from certain federal entities to provide their representations to us regarding the U.S. government's consolidated financial statements. Treasury and OMB were unable to provide us with adequate representations regarding the U.S. government's accrual-based consolidated financial statements for fiscal years 2012 and 2011 primarily because of insufficient representations provided to them by certain federal entities.

Material Weaknesses Resulted in Ineffective Internal Control over Financial Reporting

The material weaknesses discussed in this report resulted in ineffective internal control over financial reporting. Consequently, the federal government's internal control did not provide reasonable assurance that misstatements, losses, or noncompliance material in relation to the consolidated financial statements would be prevented or detected and corrected on a timely basis. The federal government is responsible for establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness. Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial

statements in conformity with U.S. GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements.

In planning and performing our audit, we considered internal control over financial reporting. We did not consider all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We do not express an opinion on the effectiveness of internal control over financial reporting because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal control. Based on the scope of our work and the effects of the other limitations on the scope of our audit noted throughout this report, our internal control work would not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.¹⁹ Further, our internal control work may not be sufficient for other purposes.

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, which were discussed previously, we found the following four other material weaknesses in internal control. These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments,
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis,
- effectively manage its tax collection activities, and
- effectively monitor and report loans receivable and loan guarantee liabilities.

These material weaknesses are discussed in more detail in appendix III, including the primary effects of the material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

We also found a significant deficiency in the federal government's internal control over management of federal grants related to deficiencies at certain federal entities. This significant deficiency is discussed in more detail in appendix IV.

Further, individual federal entity financial statement audit reports identified additional control deficiencies that were reported by the entities' auditors as either material weaknesses or significant deficiencies at the individual entity level. We do not consider these additional deficiencies to represent material weaknesses or significant deficiencies with respect to the consolidated financial statements.

¹⁹A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance with Laws and Regulations

Our work to test compliance with selected provisions of laws and regulations that have a direct and material effect on the consolidated financial statements was limited by the material weaknesses and other scope limitations discussed in this report. U.S. generally accepted government auditing standards and OMB guidance require auditors to report on entities' compliance with selected provisions of laws and regulations. Certain individual entity audit reports contain instances of noncompliance. None of these instances were deemed to be reportable noncompliance with regard to the accompanying consolidated financial statements.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with laws and regulations.

Required Supplementary Information, Required Supplementary Stewardship Information, and Other Information

U.S. generally accepted accounting principles require that required supplementary information (RSI)²⁰ and required supplementary stewardship information (RSSI)²¹ be presented in the *2012 Financial Report* to supplement the financial statements. This information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB), which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the RSI and RSSI in accordance with U.S. generally accepted government auditing standards because of the material weaknesses and other scope limitations discussed in this report. We did not audit and we do not express an opinion or provide any assurance on the RSI or RSSI.

Other information included in the *2012 Financial Report* contains a wide range of information, some of which is not directly related to the consolidated financial statements.²² This information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements, RSI, or RSSI. An objective of our audit was to form an opinion on the consolidated financial statements. We did not audit and do not express an opinion or provide any assurance on the other information in the *2012 Financial Report*.

Readers are cautioned that the material weaknesses and scope limitations discussed in this audit report, including those related to our disclaimers of opinion on the 2012, 2011, and 2010 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, affect the reliability of certain information contained in the RSI, RSSI, and other information that is taken from the same data sources as the accrual-based consolidated financial statements; the 2012, 2011, and 2010 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts.

²⁰RSI is comprised of Management's Discussion and Analysis and information in the Required Supplementary Information section of the *2012 Financial Report*.

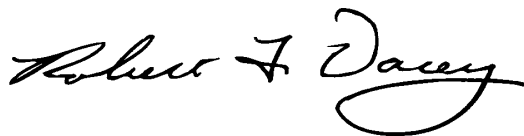
²¹RSSI is comprised of information on stewardship investments in the Required Supplementary Stewardship Information section of the *2012 Financial Report*.

²²Other information is comprised of information in the *2012 Financial Report* other than the consolidated financial statements, RSI, RSSI, the auditor's report, and the Statement of the Comptroller General of the United States.

CFO Act Agency Financial Management Systems

The federal government's ability to efficiently and effectively manage and oversee its day-to-day operations and programs relies heavily on the ability of entity financial management systems to produce complete, reliable, timely, and consistent financial information for use by executive branch agencies and Congress.²³ FFMIA was designed to lead to system improvements that would result in CFO Act agency managers routinely having access to reliable, useful, and timely financial-related information to measure performance and increase accountability throughout the year. FFMIA requires auditors, as part of the 24 CFO Act agencies' financial statement audits, to report whether those agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's U.S. Standard General Ledger at the transaction level. For both fiscal years 2012 and 2011, auditors for 11 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more of the three FFMIA requirements. Agency management at the 24 CFO Act agencies also annually report on FFMIA compliance. For fiscal years 2012 and 2011, agency management at 9 and 7 of the CFO Act agencies, respectively, reported that their agencies' financial management systems were not in substantial compliance with one or more of the three FFMIA requirements. Based on agency financial reports, the differences in the assessments of substantial compliance between the auditors and agency management reflected differences in views between management and the auditors on the impact reported deficiencies had on agencies' financial management systems. Long-standing financial management systems weaknesses at several large CFO Act agencies, along with the size and complexity of the federal government, continue to present a formidable management challenge in providing accountability to the nation's taxpayers and have contributed significantly to the material weaknesses and other limitations that have resulted in our disclaimers of opinion on the accrual-based consolidated financial statements.

We provided a draft of this report to Treasury and OMB officials, who provided technical comments, which have been incorporated as appropriate. Treasury and OMB officials expressed their continuing commitment to address the problems this report outlines.



Robert F. Dacey
Chief Accountant
U.S. Government Accountability Office

January 9, 2013

²³FFMIA defines the term "financial management systems" to include the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

Appendix I

Objectives, Scope, and Methodology

Our objectives were to audit the consolidated financial statements for the fiscal years ended September 30, 2012 and 2011, including the Statements of Changes in Social Insurance Amounts for 2012 and 2011, and the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance, along with reporting on internal control over financial reporting and on compliance with selected provisions of laws and regulations.

The Chief Financial Officers Act of 1990 (CFO Act), as expanded by the Government Management Reform Act of 1994 (GMRA), requires the inspectors general of the 24 CFO Act agencies to be responsible for annual audits of agencywide financial statements prepared by these agencies.²⁴ GMRA requires GAO to be responsible for the audit of the U.S. government's consolidated financial statements,²⁵ and the Accountability of Tax Dollars Act of 2002 (ATDA) requires most other executive branch entities to prepare and have audited annual financial statements.²⁶ The Office of Management and Budget and the Department of the Treasury (Treasury) have identified 35 federal entities that are significant to the U.S. government's consolidated financial statements, consisting of the 24 CFO Act agencies, several other federal executive branch agencies, and some government corporations (35 significant entities).²⁷ Our work was performed in coordination and cooperation with the inspectors general and independent public accountants for these 35 significant entities to achieve our respective audit objectives. Our audit approach regarding the accrual-based consolidated financial statements primarily focused on determining the current status of the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements and the other material weaknesses affecting internal control that we had reported in our report on the consolidated financial statements for fiscal year 2011.²⁸ We also separately audited the financial statements of certain federal entities and federal agency components, including the following.

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2012 and 2011 financial statements.²⁹ In fiscal years 2012 and 2011, IRS collected about \$2.5 trillion and \$2.4 trillion, respectively, in tax payments and paid about \$373 billion and \$416 billion, respectively, in refunds to taxpayers. For fiscal year 2012, we continued to report a material weakness in internal control over unpaid tax assessments that resulted in ineffective internal control over financial reporting. In addition, we reported a significant deficiency in IRS's internal control over financial reporting systems. Due to the cumulative effects of corrective actions taken by IRS over the years and in fiscal year 2012, deficiencies related to financial reporting systems no longer collectively constitute a material weakness as we reported in each of our previous audits of IRS's financial statements.

²⁴31 U.S.C. 3521(e). GMRA authorized the Office of Management and Budget to designate agency components that also would receive a financial statement audit. See 31 U.S.C. 3515(c).

²⁵GMRA, Pub. L. No. 103-356, § 405(c), 108 Stat. 3410, 3416-17 (Oct. 13, 1994), *codified at* 31 U.S.C. 331 (e)(2).

²⁶ATDA, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002), *codified at* 31 U.S.C. 3515.

²⁷See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 entities.

²⁸For our report on the U.S. government's consolidated financial statements for fiscal year 2011, see Department of the Treasury, *2011 Financial Report of the United States Government* (Washington, D.C.: December 2011), 211-231, which can be found on GAO's website at www.gao.gov/financial.html.

²⁹GAO, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-120 (Washington, D.C.: Nov. 9, 2012).

However, these deficiencies, which include both recurring and newly identified issues, are collectively important enough to merit the attention of those charged with governance. We also reported that we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested. Further, we found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996.

- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2012 and 2011.³⁰ For these 2 fiscal years, the schedules reported (1) approximately \$11.3 trillion (2012) and \$10.1 trillion (2011) of federal debt held by the public;³¹ (2) about \$4.8 trillion (2012) and \$4.7 trillion (2011) of intragovernmental debt holdings;³² and (3) about \$245 billion (2012) and \$251 billion (2011) of interest on federal debt held by the public. We reported that as of September 30, 2012, BPD had effective internal control over financial reporting relevant to the Schedule of Federal Debt. Further, we reported that we found no reportable noncompliance in fiscal year 2012 with selected provisions of laws related to the Schedules of Federal Debt we tested.
- We audited and expressed unqualified opinions on the fiscal years 2012 and 2011 financial statements of the U.S. Securities and Exchange Commission (SEC) and its Investor Protection Fund (IPF).³³ We also reported that as of September 30, 2012, although SEC's internal controls could be improved, SEC had effective internal control over financial reporting for both the entity as a whole and the IPF. In addition, we reported that we found no reportable noncompliance for either SEC or IPF in fiscal year 2012 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the fiscal years 2012 and 2011 financial statements of the Federal Housing Finance Agency (FHFA).³⁴ We reported that FHFA had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the Office of Financial Stability's (OFS) fiscal years 2012 and 2011 financial statements for the Troubled Asset Relief Program (TARP).³⁵ We reported that OFS had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested.

³⁰GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2012 and 2011 Schedules of Federal Debt*, GAO-13-114 (Washington, D.C.: Nov. 8, 2012).

³¹The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, foreign governments, and central banks.

³²Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.

³³GAO, *Financial Audit: Securities and Exchange Commission Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-122R (Washington, D.C.: Nov. 15, 2012).

³⁴GAO, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-124R (Washington, D.C.: Nov. 15, 2012).

³⁵GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-126R (Washington, D.C.: Nov. 9, 2012).

- We audited and expressed an unqualified opinion on the fiscal years 2012 and 2011 financial statements of the Bureau of Consumer Financial Protection (CFPB).³⁶ We reported that CFPB had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance for fiscal year 2012 with the selected provisions of laws and regulations we tested.

In addition, we considered the CFO Act agencies' and certain other federal entities' fiscal years 2012 and 2011 financial statements and the related auditors' reports prepared by the inspectors general or contracted independent public accountants. Financial statements and audit reports for the 35 significant entities provide information about the operations of each of these entities. The entity audit reports also contain details regarding any audit findings and related recommendations for the respective entity. We did not audit, and we do not express an opinion on, any of these individual federal entity financial statements.

We considered the Department of Defense's (DOD) assertion in the *DOD Agency Financial Report for Fiscal Year 2012* regarding its noncompliant financial systems and lack of reasonable assurance that internal controls over financial reporting were effective. In addition, in the DOD Inspector General's fiscal year 2012 report on internal control over financial reporting, the Inspector General cited material weaknesses in several areas, including (1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations; and (5) material amounts of unsupported accounting entries needed to prepare DOD's annual consolidated financial statements.

Because of the significance of the amounts presented in the Statements of Social Insurance and Statements of Changes in Social Insurance Amounts related to the Social Security Administration (SSA) and the Department of Health and Human Services (HHS), our audit approach regarding these statements focused primarily on these two agencies. For each federal entity preparing a Statement of Social Insurance and Statement of Changes in Social Insurance Amounts,³⁷ we considered the entity's 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, as well as the related auditor's reports prepared by the inspectors general or contracted independent public accountants. We believe our audit, including internal control and substantive audit procedures, reperformance procedures, and review of the other auditors' Statement of Social Insurance-related audit work, provides a reasonable basis for our opinions on the 2009 and 2008 Statements of Social Insurance.

We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and compliance with selected provisions of laws and regulations. We considered the limitations on the scope of our work regarding the accrual-based consolidated financial statements; the 2012, 2011, and 2010 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

³⁶GAO, *Financial Audit: Bureau of Consumer Financial Protection's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-125R (Washington, D.C.: Nov. 15, 2012).

³⁷These entities are SSA, HHS, the Railroad Retirement Board, and the Department of Labor.

Appendix II

Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual-Based Consolidated Financial Statements

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual-based consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the accompanying accrual-based consolidated financial statements, as described below.

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 accrual-based 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. Certain other entities reported continued deficiencies in internal control procedures and processes related to PP&E.

Deficiencies in internal control over such assets could affect the federal government's ability to fully know the assets it owns, including their location and condition, and its ability to effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets and reliably report asset balances; (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.

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 any related to treaties and other international agreements entered into to further the federal 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, deficiencies in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as adversely 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, to the extent disclosures of

commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

Reported net costs were affected by the previously discussed material weaknesses in reporting assets and liabilities; material weaknesses in financial statement preparation, as discussed below; and the lack of adequate disbursement reconciliations at certain federal entities. As a result, the federal government was unable to support significant portions of the reported total net cost of operations, most notably those related to DOD.

With respect to disbursements, DOD and certain other federal entities reported continued material weaknesses and significant deficiencies in reconciling disbursement activity. For fiscal years 2012 and 2011, unreconciled disbursement activity, including unreconciled differences between federal entities' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal entity adjustments, totaled 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 or authorized. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal entities for inclusion in *The Budget of the United States Government* (President's Budget) concerning obligations and outlays.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Although progress has been made, federal entities continue to be unable to adequately account for and reconcile intragovernmental activity and balances. The federal government's progress varies by category.³⁸ The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 significant entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these entities are required to report to Treasury, their respective inspectors general, and GAO on the extent and results of intragovernmental activity and balance-reconciliation efforts as of the end of the fiscal year.

As in prior years, a substantial number of the entities did not adequately perform the required year-end reconciliations for fiscal year 2012. Based on trading partner information provided to Treasury in the 35 significant entities' closing packages, Treasury provided a *Material Differences Report* to each entity showing amounts for certain intragovernmental activity and balances that significantly differed from those of the entity's corresponding trading partners as of the end of the fiscal year. Entities are required to complete their *Material Differences Reports*, including providing explanations of the reasons for certain differences. Based on our review of completed *Material Differences Reports* for fiscal year 2012, we continue to note that amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. We noted that several CFOs cited differing accounting methodologies, accounting errors, and timing differences for unreconciled amounts reported in

³⁸Treasury has grouped intragovernmental activities and balances into five broad categories.

their *Material Differences Reports*. Some CFOs indicated that they did not know the reason for the differences. In addition, some CFOs confirmed the balance or activity, but differences continued to exist.

Further, there continue to be hundreds of billions of dollars of unreconciled differences between the General Fund of the U.S. Government and federal entity trading partners related to appropriations and other intragovernmental transactions. The ability to reconcile such transactions is hampered because only some of the General Fund of the U.S. Government is reported in Treasury's department-level financial statements. As a result of these circumstances, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

During fiscal year 2012, Treasury expanded its ongoing efforts to help resolve and eliminate material differences in intragovernmental activity and balances. These efforts included developing and implementing a formalized resolution plan and related corrective actions intended to address long-standing intragovernmental challenges. As part of its plan, Treasury monitors entities' reconciliation efforts and compliance with *Treasury Financial Manual* guidance. For example, Treasury began a pilot program with 14 entities that included providing them with quarterly metrics/scorecards highlighting differences requiring attention. In fiscal year 2013, Treasury plans to expand the distribution of the quarterly metrics/scorecards to include all 35 significant entities. Further, Treasury is in the process of establishing separate reporting for the General Fund, which includes intragovernmental transactions. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong and sustained commitment by federal entities to timely resolve differences with their trading partners, as well as continued strong leadership by OMB and Treasury.

Preparation of Consolidated Financial Statements

While Treasury, in coordination with OMB, implemented corrective actions during fiscal year 2012 to address certain internal control deficiencies detailed in our previously issued report, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (U.S. GAAP). During our fiscal year 2012 audit, we found the following.³⁹

- Treasury's process for compiling the consolidated financial statements generally demonstrated that amounts in the Statement of Social Insurance and the Statement of Changes in Social Insurance Amounts were consistent with the underlying federal entities' financial statements and that the Balance Sheet and the Statement of Net Cost were also consistent with the 35 significant federal entities' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process did not ensure that the information in the remaining three principal financial statements (Statement of Operations and Changes in Net Position, Reconciliation of Net Operating Cost and Unified

³⁹Most of the issues we identified in fiscal year 2012 existed in fiscal year 2011, and many have existed for a number of years. Most recently, in June 2012, we reported the issues we identified to Treasury and OMB and provided recommendations for corrective action. See GAO, *Management Report: Improvements Needed in Controls over the Preparation of the U.S. Consolidated Financial Statements*, GAO-12-529 (Washington, D.C.: June 27, 2012).

Budget Deficit, and Statement of Changes in Cash Balance from Unified Budget and Other Activities) was fully consistent with the underlying information in the 35 significant federal entities' audited financial statements and other financial data.

- For fiscal year 2012, auditors reported internal control deficiencies at several entities regarding entities' financial reporting processes that could affect information included in the respective entities' closing packages.⁴⁰ Further, Treasury had to record significant adjustments to correct errors found in federal entities' audited closing package information. To ensure consistency of underlying entity information and financial data with the U.S. government's consolidated financial statements, entity auditors are required to separately audit and report on the financial information that the 35 significant federal entities send to Treasury through closing packages.
- Treasury is unable to properly balance the accrual-based consolidated financial statements. To make the fiscal years 2012 and 2011 consolidated financial statements balance, Treasury recorded net increases of \$20.2 billion and \$15.6 billion, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which were identified as "Unmatched transactions and balances."⁴¹ Treasury recorded an additional net \$1.8 billion and \$6.0 billion of unmatched transactions in the Statement of Net Cost for fiscal years 2012 and 2011, respectively. The material weakness in federal entities' ability to account for and reconcile intragovernmental activity and balances, discussed above, significantly contributes to the unmatched transactions and balances and consequently impairs Treasury's ability to fully eliminate such intragovernmental activity and balances.
- The federal government has not established and implemented effective processes and procedures for identifying and reporting all items needed to (1) prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities and (2) reconcile the operating results to the budget results. Typical reconciling items would include both accrual-based costs that are not yet recognized in the unified budget deficit and budget costs that are not yet recognized in the net operating cost.
- Over the past several years, significant actions have been taken to assist in ensuring that financial information is reported or disclosed in the consolidated financial statements in conformity with U.S. GAAP. However, Treasury's reporting of certain financial information required by U.S. GAAP continues to be impaired. Due to certain control deficiencies noted in this report—for example, commitments and contingencies related to treaties and other international agreements—Treasury is precluded from determining if additional disclosure is required by U.S. GAAP in the consolidated financial statements, and we are precluded from determining whether the omitted information is material. Further, Treasury's ability to report information in conformity with U.S. GAAP will also remain impaired until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

⁴⁰The closing package methodology links federal entities' audited consolidated department-level financial statements to certain of the U.S. government's consolidated financial statements.

⁴¹Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relates to net operating cost, it reported this amount as a component of net operating cost in the accompanying consolidated financial statements.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal entities within those branches have provided Treasury such information. However, as we have reported in past years, undetermined amounts of assets, liabilities, costs, and revenues are not included, and the federal government did not provide evidence that the excluded financial information was immaterial.
- Other internal control deficiencies existed in the process for preparing the consolidated financial statements, involving (1) inadequate design and ineffective implementation of policies and procedures related to certain areas, such as analysis of federal entity-provided data, journal vouchers, and calendar year-end entities and (2) inadequate processes for monitoring and assessing internal controls over the preparation of the consolidated financial statements. As a result, we identified errors in draft consolidated financial statements that were subsequently corrected.
- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2012 financial reporting challenges it faced, such as control deficiencies in its process for preparing the consolidated financial statements noted above. We found that there were not enough personnel in Treasury's Financial Management Service with specialized financial reporting experience to help ensure reliable financial reporting. In addition, the federal government does not perform interim compilations at the government-wide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year. Treasury has taken various steps to begin to address these issues, including (1) obtaining and utilizing certain interim financial information from federal entities in preparing initial financial statement drafts, (2) supplementing staff during the financial report preparation process, and (3) considering opportunities resulting from the ongoing consolidation of operations of Treasury's Financial Management Service and Bureau of the Public Debt.

Until these internal control deficiencies have been fully addressed, the federal government's ability to ensure that the consolidated financial statements are consistent with the underlying audited federal entities' financial statements, properly balanced, and in conformity with U.S. GAAP will be impaired. Resolving these internal control deficiencies remains a difficult challenge and will require a strong and sustained commitment from Treasury and OMB as they continue to execute and implement their corrective action plans.

Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and the Statement of Changes in Cash Balance from Unified Budget and Other Activities report a unified budget deficit for fiscal years 2012 and 2011 of about \$1.1 trillion and \$1.3 trillion, respectively.⁴² The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts). Also, the Fiscal Projections for the U.S. Government included in the

⁴²The budget deficit, receipts, and outlays amounts are reported in Treasury's *Monthly Treasury Statement* and the President's Budget.

unaudited Required Supplementary Information section of the *2012 Financial Report* use such outlays and receipts.

For several years, we have been reporting significant unreconciled differences between the total net outlays reported in selected federal entities' Statements of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit reported in the consolidated financial statements. Unreconciled net outlays of about \$55 billion and \$31 billion existed for fiscal years 2012 and 2011, respectively. OMB and Treasury have recognized that it will take a coordinated effort to establish effective processes and procedures for identifying, resolving, and explaining material differences in this and other components of the deficit between Treasury's central accounting records and information reported in entity financial statements and underlying entity financial information and records. Until these types of differences are reconciled in a timely manner by the federal government, their effect on the U.S. government's consolidated financial statements will continue to be unknown. In fiscal year 2012, Treasury began to develop a methodology for reconciling operating revenue to budget receipts on a government-wide basis. In addition, an external organization performed a broad review of the government-wide financial report preparation process and provided several recommendations for improvements, including some related to reconciling components of the budget deficit. Treasury stated that it will consider these recommendations in developing its methodology.

In fiscal year 2012, we again noted that several entities' auditors reported internal control deficiencies (1) affecting the entities' SBRs and (2) related to monitoring, accounting, and reporting of budgetary transactions. These control deficiencies could affect the reporting and calculation of the net outlay amounts in the entities' SBRs. In addition, such deficiencies may also affect the entities' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget deficit reported in the accrual-based consolidated financial statements. The unified budget deficit is also reported by Treasury in its *Combined Statement of Receipts, Outlays, and Balances*,⁴³ and in other federal government publications.

⁴³Treasury'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 entity reporting.

Appendix III

Other Material Weaknesses

Material weaknesses in internal control discussed in this report resulted in ineffective controls over financial reporting. In addition to the material weaknesses discussed in appendix II that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, we found the following four other material weaknesses in internal control.

Improper Payments

Reducing improper payments is critical to safeguarding federal funds.⁴⁴ During fiscal year 2012, the federal government continued to make progress in identifying and reporting on improper payments. Entities reported improper payment estimates for nine additional programs when compared to fiscal year 2011.⁴⁵ Most notably, the Department of Health and Human Services (HHS) reported an estimated improper payment amount for the Children's Health Insurance Program of \$704 million. Nevertheless, the federal government continues to face challenges in determining the full extent of improper payments. For example, four federal entities did not report fiscal year 2012 estimated improper payment amounts for 10 risk-susceptible programs, including HHS's Temporary Assistance for Needy Families. The Improper Payments Information Act of 2002 (IPIA), as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA),⁴⁶ requires federal executive branch entities to (1) review all programs and activities, (2) identify those that may be susceptible to significant improper payments, (3) estimate the annual amount of improper payments for those programs and activities, (4) implement actions to reduce improper payments and set reduction targets, and (5) report on the results of addressing the foregoing requirements. IPERA also established a requirement for entity inspectors general to report annually on entities' compliance, as defined in IPERA. In March 2012, the inspectors general began issuing their reports under this requirement covering fiscal year 2011. The reports identified issues such as improper risk assessment methods used by entities to identify programs and activities susceptible to significant improper payments, estimates not being reported for susceptible programs, and improper payment reduction targets not being set.

⁴⁴Under the Improper Payments Information Act of 2002, as amended, improper payments are statutorily defined as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible good or service, any duplicate payment, any payment for a good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts.

⁴⁵Of the nine programs, the Office of Management and Budget (OMB) excluded four programs from its government-wide totals because those programs did not have OMB-approved sampling methodologies for estimating improper payments.

⁴⁶IPIA, Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002), as amended by IPERA, Pub. L. No. 111-204, 124 Stat. 2224 (July 22, 2010), and reprinted in 31 U.S.C. 3321 note. As of the date of this report, H.R. 4053, the Improper Payments Elimination and Recovery Improvement Act of 2012, was awaiting the President's signature. The Act would require federal entities to take additional steps to identify and prevent improper payments. The Act would enact into law elements of the President's "Do Not Pay List" initiative by requiring entities to review prepayment and pre-award procedures and ensure a thorough review of available databases to determine program or award eligibility before the release of any federal funds. The Act would also direct OMB to annually identify a list of high-priority federal programs for greater levels of oversight and review and would require each entity responsible for one of these high-priority programs to annually submit a program report to its inspector general and make a report copy available to the public.

The Office of Management and Budget (OMB) reported total federal entity improper payment estimates of \$107.7 billion in fiscal year 2012. This is a decrease from the prior year revised estimate of \$115.7 billion as reported by federal entities.⁴⁷ These estimates represented about 4.4 percent and 4.7 percent of reported outlays for the associated programs in fiscal years 2012 and 2011, respectively. Decreases in reported estimates of improper payments were mostly attributable to four major programs: the decreases for the Department of Labor's Unemployment Insurance and the Department of the Treasury's Earned Income Tax Credit programs were attributable to decreases in reported outlays, and the decreases for HHS's Medicaid and the Social Security Administration's Old-Age, Survivors, and Disability Insurance programs were attributable to decreases in reported error rates.⁴⁸ It is important to note that, pursuant to OMB implementing guidance, reported improper payment estimates include overpayments, underpayments, and payments for which adequate documentation was not found, and may also include amounts of payments for years prior to the current fiscal year.

In addition to the issues reported by entity inspectors general as noted above, entity auditors continued to report internal control deficiencies over financial reporting, such as financial system limitations and information system control weaknesses, which significantly increase the risk that improper payments may occur and not be detected promptly.

Until the federal government has implemented effective processes to determine the full extent to which improper payments occur and appropriate actions are taken across entities and programs to effectively reduce improper payments, the federal government will not have reasonable assurance that the use of federal funds is adequately safeguarded.

Information Security

Although progress has been made, serious and widespread information security control deficiencies reported during fiscal year 2012 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. Specifically, control deficiencies were identified related to (1) security management; (2) access to computer resources (data, equipment, and facilities); (3) changes to information system resources; (4) segregation of incompatible duties; and (5) contingency planning. We have reported information security as a high-risk area across government since February 1997.

Such information security control deficiencies unnecessarily increase the risk that data recorded in or transmitted by federal financial management systems are not reliable and available. A primary reason for these deficiencies is that federal entities generally have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control deficiencies, resolving information security problems, and managing information security risks on an ongoing basis. The federal government has taken important actions to improve information security, such as enhancing performance measures and

⁴⁷In their fiscal year 2012 Performance and Accountability Reports (PAR) and Annual Financial Reports (AFR), three federal entities updated their fiscal year 2011 improper payment estimates to reflect changes since issuance of their fiscal year 2011 PARs and AFRs. These updates increased the government-wide improper payment estimate for fiscal year 2011 from \$115.3 billion to \$115.7 billion.

⁴⁸Reported error rates reflect the estimated improper payments as a percentage of total program outlays.

reporting processes necessary for monitoring and assessing the effectiveness of agencies' information security programs. In addition, the administration established goals to achieve, by the end of fiscal year 2014, 95 percent use of (1) trusted Internet connections to consolidate external telecommunication access points; (2) continuous monitoring of federal information systems; and (3) strong authentication through the increased use of federal smart card credentials, such as Personal Identity Verification and Common Access Cards. Until entities identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2012, a material weakness continued to affect the federal government's ability to effectively manage its tax collection activities. Due to financial system limitations, as well as errors and delays in recording taxpayer information, the federal government's records did not always reflect the correct amount of taxes owed by the public to the federal government. Such errors and delays may cause undue burden and frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts. Collectively, these deficiencies indicate that internal controls were not effective in (1) ensuring that reported amounts of taxes receivable and other tax assessments were accurate on an ongoing basis and could be relied upon by management as a tool to aid in making and supporting resource allocation decisions and (2) supporting timely and reliable financial statements, accompanying notes, and required supplementary information and other information without extensive supplemental procedures and adjustments.

Loans Receivable and Loan Guarantee Liabilities

Internal control deficiencies were identified at certain federal entities that accounted for the majority of the reported balances for loans receivable and loan guarantee liabilities. The deficiencies related to monitoring and reporting loan and loan-related activity, and to credit subsidy estimation and related financial reporting processes. In fiscal year 2012, the Department of Education, which accounted for the largest reported balance of loans receivable, experienced internal control deficiencies related to the implementation of new debt management collection and direct loan servicing systems. The department's deficiencies affected, among other things, its ability to process certain types of transactions, prepare certain system reconciliations in a timely manner, and properly report interest accruals.

Such deficiencies and issues, and complexities associated with estimating the costs of lending and other loan-related financing activities, significantly increase the risk that misstatements in entity and government-wide financial statements could occur and go undetected. Further, control deficiencies related to estimating the costs of lending and other loan-related financing activities can 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.

Appendix IV

Significant Deficiency

In addition to the material weaknesses discussed in appendixes II and III, we found a significant deficiency in the federal government's internal control over management of federal grants, related to deficiencies at certain federal entities. Also, we reported a significant deficiency in fiscal year 2011 regarding loans receivable and loan guarantee liabilities. We considered the control deficiencies in loans receivable and loan guarantee liabilities to be a material weakness in fiscal year 2012, as noted above, as additional control deficiencies in this area were identified in fiscal year 2012.

Federal Grants Management

In fiscal year 2012, federal grants management internal control deficiencies, primarily regarding inadequate monitoring and oversight of grant programs, were identified at several federal entities. For example, the auditor of one federal entity that awards and manages significant amounts of grants reported that related information and communication systems did not collect and disseminate timely, reliable, and relevant information to those charged with making informed decisions regarding grants. Additionally, another entity's auditor reported that effective monitoring procedures over certain grant activities and the maintenance of related documentation have not been implemented. These internal control deficiencies could adversely affect the federal government's ability to ensure that grant funds are being used in accordance with applicable program laws and regulations.