



**Comptroller General
of the United States**

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

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 (OMB), is required annually to submit financial statements for the U.S. government to the President and the Congress. GAO is required to audit these statements.¹ This is our report on the accompanying U.S. government's consolidated financial statements for the fiscal years ended September 30, 2005 and 2004,² and our associated reports on internal control and compliance with significant laws and regulations.

The federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP); (2) establishing, maintaining, and assessing 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 significant laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies⁴ are responsible for implementing and maintaining financial management systems that substantially comply with Federal Financial Management Improvement Act of 1996 (FFMIA)⁵ requirements. Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2005 and 2004. Appendix I discusses the scope and methodology of our work.

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 consolidated financial statements for the fiscal years ended September 30, 2005 and 2004, consist of the Statements of Net Cost, Statements of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Unified Budget Deficit, Statements of Changes in Cash Balance from Unified Budget and Other Activities, and Balance Sheets, including the related notes to these financial statements.

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

⁴31 U.S.C. 901(b). The Federal Emergency Management Agency (FEMA) was transferred to the new Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA is no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for fiscal year 2004. For fiscal year 2004, DHS was required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002). The DHS Financial Accountability Act, Pub. L. No. 108-330, 118 Stat. 1275 (Oct. 16, 2004), added DHS to the list of CFO Act agencies and deleted FEMA, increasing the number of CFO Act agencies again to 24 for fiscal year 2005. With this designation, DHS is required to implement and maintain financial management systems that comply with FFMIA and its auditors are required to report on DHS's financial management systems' compliance with FFMIA beginning with fiscal year 2005. Also beginning in fiscal year 2005, the law requires that the Secretary of DHS include in its performance and accountability report an assertion on the internal control over financial reporting. DHS's auditors will be required to opine on such internal control beginning in fiscal year 2006.

⁵31 U.S.C. 3512 note (Federal Financial Management Improvement Act).

A significant number of material weaknesses⁶ related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation 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 economical, efficient, and effective manner. We found the following:

Material deficiencies in financial reporting (which also represent material weaknesses) and other limitations on the scope of our work resulted in conditions that continued to prevent us from expressing an opinion on the accompanying consolidated financial statements for the fiscal years ended September 30, 2005 and 2004.⁷

- 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 and scope limitations discussed in this report.

DISCLAIMER OF OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. government's accompanying consolidated financial statements for fiscal years 2005 and 2004, principally resulting from the material deficiencies, and other limitations on the scope of our work, described in this report, we are unable to, and we do not, express an opinion on such financial statements.

As a result of the material deficiencies in the federal government's systems, recordkeeping, documentation, and financial reporting and scope limitations, readers are cautioned that amounts reported in the consolidated financial statements and related notes may not be reliable. These material deficiencies and scope limitations also affect the reliability of certain information contained in the accompanying Management's Discussion and Analysis and other financial management information—including information used to manage the government day to day and budget information reported by federal agencies—that is taken from the same data sources as the consolidated financial statements.

⁶A 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.

⁷We previously reported that material deficiencies prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2004.

We have not audited and do not express an opinion on the Management's Discussion and Analysis, Stewardship Information, Supplemental Information, or other information included in the accompanying fiscal year 2005 *Financial Report of the United States Government*.

Significant Matters of Emphasis

Before discussing the material deficiencies and the additional limitations on the scope of our work we identified, two significant matters require emphasis—the nation's fiscal imbalance and restatements of certain agencies' prior-year financial statements.

The Nation's Fiscal Imbalance

While we are unable to express an opinion on the U.S. government's consolidated financial statements, several key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *Financial Report of the United States Government* into context. First, while the reported \$319 billion fiscal year 2005 unified budget deficit was significantly lower than the \$412 billion unified budget deficit in fiscal year 2004, it was still very high given current economic growth rates and the overall composition of federal spending.⁸

Furthermore, the federal government's reported net operating cost, which included expenses incurred during the year, increased to \$760 billion in fiscal year 2005 from \$616 billion in fiscal year 2004. Second, the U.S. government's total reported liabilities, net social insurance commitments⁹ and other fiscal exposures continue to grow and now total more than \$46 trillion, representing close to four times current GDP and up from about \$20 trillion or two times GDP in 2000. Finally, while the nation's long-term fiscal imbalance continues to grow, the retirement of the "baby boom" generation is closer to becoming a reality with the first wave of boomers eligible for early retirement under Social Security in 2008. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary in order to address the nation's large and growing long-term fiscal imbalance.

Potential Impact of Restatements

We continue to have concerns about the identification of misstatements in federal agencies' prior year financial statements. At least 7¹⁰ of the 24 CFO Act agencies restated certain of their fiscal year 2004 financial statements to correct errors. During fiscal year

⁸The reported on-budget deficits for fiscal years 2005 and 2004 were \$494 billion and \$567 billion, respectively. The transactions of the Postal Service and the Social Security trust funds are classified as off-budget. As such, their reported fiscal year 2005 and 2004 surpluses—\$2 billion and \$4 billion, respectively, for the Postal Service and \$173 billion and \$151 billion, respectively, for the Social Security trust funds—are excluded from the on-budget deficit but included in the unified budget deficit.

⁹These amounts are calculated based on the present value of net social insurance obligations for a 75 year period computed on an open group basis.

¹⁰Three of these agencies had received an unqualified opinion on their originally issued fiscal year 2004 financial statements while the remaining four of the seven agencies had received a disclaimer of opinion on their financial statements. The auditor for one of the agencies withdrew the unqualified opinion that had been previously rendered on the agency's fiscal year 2004 financial statements and issued a qualified opinion on the restated financial statements.

2005, we reviewed the causes and nature of the restatements made by certain CFO Act agencies to their fiscal year 2003 financial statements and recommended improvements in internal controls and audit procedures to prevent or detect future similar errors. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. The material internal control weaknesses discussed in this report serve to increase the risk that additional errors may occur and not be identified on a timely basis by agency management or their auditors, resulting in further restatements.

Limitations on the Scope of Our Work

For fiscal year 2005, there were limitations on the scope of our work in addition to the material deficiencies. Specifically, Treasury was unable to provide us with complete and properly supported drafts of the U.S. government's consolidated financial statements in time for us to complete all of our planned auditing procedures related to the compilation of these financial statements.

Treasury and OMB depend on certain federal agencies' representations to provide their representations to us regarding the U.S. government's consolidated financial statements. For fiscal year 2005, Treasury and OMB were unable to provide us with adequate representations regarding the U.S. government's consolidated financial statements primarily because of insufficient representations provided to them by two CFO Act agencies.

For fiscal year 2004, additional limitations on the scope of our work related to (1) the timing of receipt of the U.S. government's consolidated financial statements, (2) the availability of certain audit documentation for several federal agencies, and (3) the adequacy of management and legal representations.

Material Deficiencies

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the accompanying consolidated financial statements, as briefly described below. These material deficiencies, which generally have existed for years, contributed to our disclaimer of opinion and also constitute material weaknesses in internal control. Appendix II describes the material deficiencies in more detail and highlights the primary effects of these material weaknesses on the accompanying consolidated financial statements and on the management of federal government operations. These material deficiencies were the federal government's inability to:

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by DOD, were properly reported in the consolidated financial statements;

- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- ensure that the federal government's consolidated financial statements were consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies; and
- resolve material differences that exist between the total net outlays reported in federal agencies' Statements of Budgetary Resources and the records used by Treasury to prepare the Statements of Changes in Cash Balance from Unified Budget and Other Activities.

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

ADVERSE OPINION ON INTERNAL CONTROL

Because of the effects of the material weaknesses discussed in this report, in our opinion, the federal government did not maintain effective internal control as of September 30, 2005, to meet the following objectives: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and stewardship information in conformity with 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 significant laws and regulations that could have a direct and material effect on the financial statements and stewardship information. Consequently, the federal government's internal control did not provide 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. Our adverse opinion on internal control over financial reporting and compliance is based upon the criteria established under FMFIA. Individual federal agency financial statement audit reports identify additional reportable conditions¹¹ in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These additional reportable conditions do not represent material weaknesses at the

¹¹Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the federal government's ability to meet the internal control objectives described in this report.

governmentwide level. Also, due to the issues noted throughout this report, additional material weaknesses may exist that have not been reported.

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

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

COMPLIANCE WITH SIGNIFICANT LAWS AND REGULATIONS

Our work to determine compliance with selected provisions of significant laws and regulations related to financial reporting was limited by the material weaknesses and scope limitations discussed above. U.S. generally accepted government auditing standards and OMB guidance require auditors to report on the agency's compliance with significant laws and regulations. Certain individual agency audit reports contain instances of noncompliance. None of these instances were material 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 significant laws and regulations.

AGENCY FINANCIAL MANAGEMENT SYSTEMS

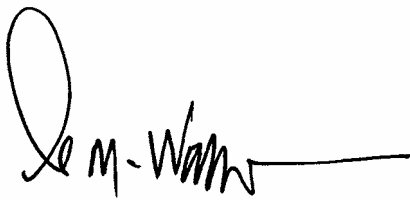
To achieve the financial management improvements envisioned by the CFO Act, FFMIA, and, more recently, the President's Management Agenda, federal agencies need to modernize their financial management systems to generate reliable, useful, and timely financial and performance information throughout the year and at year-end. As discussed throughout this report, serious financial management weaknesses have contributed significantly to our inability to determine the reliability of the consolidated financial statements. In this regard, for fiscal year 2005, auditors for the majority of the CFO Act

agencies reported material weaknesses or other reportable conditions in internal control over financial reporting.

FFMIA requires auditors, as part of the CFO Act agencies' financial statement audits, to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's *Standard General Ledger* at the transaction level. For fiscal year 2005, auditors for 19 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more of these three FFMIA requirements, compared to 16 of 23 CFO Act agencies in fiscal year 2004. The DHS Financial Accountability Act added DHS to the list of CFO Act agencies, increasing the number of CFO Act agencies to 24 for fiscal year 2005. The auditors for DHS reported for fiscal year 2005 that the agency's financial management systems did not substantially comply with any of the three FFMIA requirements. In addition, auditors for the Department of Energy and the General Services Administration reported that those agencies' financial management systems did not substantially comply with FFMIA requirements. The auditors had not reported any FFMIA compliance issues at those agencies in fiscal year 2004. As a result, the financial management systems at the majority of federal agencies are still unable to routinely produce reliable, useful, and timely financial information; and the federal government's capacity to manage with timely and objective data is limited, thereby hampering its ability to effectively administer and oversee its major programs.

- - - - -

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.

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

David M. Walker
Comptroller General
of the United States

December 2, 2005

APPENDIX I

Objectives, Scope, and Methodology

The Government Management Reform Act of 1994 expanded the requirements of the Chief Financial Officers (CFO) Act by making the inspectors general of 24 major federal agencies¹² responsible for annual audits of agencywide financial statements prepared by these agencies and GAO responsible for the audit of the U.S. government's consolidated financial statements. The Accountability of Tax Dollars (ATD) Act of 2002¹³ requires most other executive branch agencies to prepare and have audited annual financial statements. The Office of Management and Budget and the Department of the Treasury (Treasury) have identified 35 agencies¹⁴ that are significant to the U.S. government's consolidated financial statements. Our work was performed in coordination and cooperation with the inspectors general and independent public accountants for these 35 agencies to achieve our joint audit objectives. Our audit approach focused primarily on determining the current status of the material deficiencies and the other material weaknesses affecting internal control that we had previously reported in our report on the consolidated financial statements for fiscal year 2004.¹⁵ Our work included separately auditing the following significant federal agency components:

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2005 and 2004 financial statements. In fiscal years 2005 and 2004, IRS collected about \$2.3 trillion and \$2.0 trillion, respectively, in tax payments and paid about \$267 billion and \$278 billion, respectively, in refunds to taxpayers.¹⁶ In fiscal year 2005, we continued to report material internal control weaknesses, which resulted in ineffective internal control. Our tests of compliance with selected provisions of significant laws and regulations disclosed one area of noncompliance. We also 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, 2005 and 2004.¹⁷ The schedules reported for these 2 fiscal years (1) approximately \$4.6 trillion (2005) and \$4.3 trillion (2004) of federal debt held by the public;¹⁸ (2) about \$3.3 trillion (2005) and \$3.1 trillion (2004) of

¹²31 U.S.C. 901(b), 3521(e); see footnote 4. The 1994 act authorized the Office of Management and Budget to designate agency components that also would receive a financial statement audit. 31 U.S.C. 3515(c); see footnote 1.

¹³Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002).

¹⁴See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 agencies.

¹⁵For our report on the U.S. government's consolidated financial statements for fiscal year 2004, see U.S. Department of the Treasury, *Financial Report of the United States Government* (Washington, D.C. December 2004), pp. 33-53, which can be found on GAO's Internet site at www.gao.gov.

¹⁶GAO, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements*, GAO-06-137 (Washington, D.C.: Nov. 10, 2005).

¹⁷GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2005 and 2004 Schedules of Federal Debt*, GAO-06-169 (Washington, D.C.: Nov. 7, 2005).

¹⁸The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, and foreign governments and central banks.

intragovernmental debt holdings;¹⁹ and (3) about \$181 billion (2005) and \$158 billion (2004) of interest on federal debt held by the public. We reported that as of September 30, 2005, BPD had effective internal control over financial reporting and compliance with significant laws and regulations relevant to the Schedule of Federal Debt. Further, we reported that there was no reportable noncompliance in fiscal year 2005 with selected provisions of significant laws we tested.

- We audited and expressed unqualified opinions on the December 31, 2004 and 2003, financial statements of the funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund.²⁰ We reported that as of December 31, 2004, FDIC had effective internal control over financial reporting and compliance with significant laws and regulations. In addition, we performed certain procedures and tests of internal control over certain material balances of the funds administered by FDIC as of September 30, 2005.
- We audited and expressed unqualified opinions on the fiscal years 2005 and 2004 financial statements of the United States Securities and Exchange Commission (SEC).²¹ In fiscal year 2005, we continued to report material internal control weaknesses, which resulted in ineffective internal control over financial reporting. We reported that SEC had effective internal control over compliance with selected provisions of significant laws and regulations. Further, we reported that there was no reportable noncompliance with selected provisions of significant laws and regulations we tested.

We considered the CFO Act agencies' and certain other federal agencies' fiscal years 2005 and 2004 financial statements and the related auditors' reports prepared by the inspectors general or contracted independent public accountants. Financial statements and audit reports for these agencies provide information about the operations of each of these entities. We did not audit, and we do not express an opinion on, any of these individual federal agency financial statements.

We considered the Department of Defense's (DOD) assertion that DOD management prepared and submitted pursuant to the provisions of the National Defense Authorization Act for Fiscal Year 2002.²² In accordance with section 1008 of this act, DOD reported that its fiscal year 2005 financial statements were not completely reliable. DOD cited deficiencies in several areas affecting its financial statements, including among others (1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations and related accounting adjustments; and (5) disbursement activity.

¹⁹Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.

²⁰GAO, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2004 and 2003 Financial Statements*, GAO-05-281 (Washington, D.C.: Feb. 11, 2005).

²¹GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004*, GAO-06-239 (Washington, D.C.: Nov. 15, 2005).

²²Pub. L. No. 107-107, §1008, 115 Stat. 1012, 1204 (Dec. 28, 2001).

We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and the results of our assessment of compliance with selected provisions of significant laws and regulations. We considered the limitations on the scope of our work in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

APPENDIX II

Material Deficiencies

The continuing material deficiencies discussed below contributed to our disclaimer of opinion on the federal government's consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the accompanying 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 consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government's interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary

resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2005 and 2004, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and the Department of the Treasury's records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.

Preparation of Consolidated Financial Statements

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

accounting principles (GAAP). Specifically, during our fiscal year 2005 audit, we found the following:²³

- Treasury's process for compiling the consolidated financial statements did not ensure that the information in all of the 5 principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. Treasury made progress in demonstrating amounts in the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' audited financial statements prior to eliminating intragovernmental activity and balances. However, about 25 percent of the significant federal agencies' auditors reported internal control weaknesses related to the processes the agencies perform to provide financial statement information to Treasury for preparing the consolidated financial statements.
- To make the fiscal years 2005 and 2004 consolidated financial statements balance, Treasury recorded a net \$4.3 billion decrease and a net \$3.4 billion increase, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled "Unreconciled Transactions Affecting the Change in Net Position."²⁴ An additional net \$3.2 billion and \$1.2 billion of unreconciled transactions were recorded in the Statement of Net Cost for fiscal years 2005 and 2004, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2005 showed a net operating cost of \$760 billion, to the budget results, which for the same period showed a unified budget deficit of \$318.5 billion. In addition, a net \$13.2 billion "net amount of all other differences" was needed to force this statement into balance.
- Treasury's ability to eliminate certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As discussed below, amounts reported for federal agency trading partners²⁵ for certain intragovernmental accounts were significantly out of balance, resulting in the need for unsupported intragovernmental elimination entries in order to force the Statement of Operations and Changes in Net Position into balance. In addition, significant differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled and still remain unresolved. Therefore, the federal government continues to be unable to

²³Most of the issues we identified in fiscal year 2005 existed in fiscal year 2004, and many have existed for a number of years. In May 2005, we reported in greater detail on the issues we identified in GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Continues to Need Improvement*, GAO-05-407 (Washington, D.C.: May 4, 2005). This report includes numerous recommendations to Treasury and OMB.

²⁴Although Treasury was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the accompanying consolidated financial statements.

²⁵Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

determine the impact of unreconciled intragovernmental activity and balances to the consolidated financial statements.

- Treasury lacked a process to ensure that fiscal years 2005 and 2004 consolidated financial statements and notes were comparable. Certain information reported for fiscal 2004 may require reclassification to be comparable to the fiscal year 2005 amounts. However, Treasury did not analyze this information or reclassify amounts within various financial statement line items and notes to enhance comparability. For example, the Reconciliations of Net Operating Cost and Unified Budget Deficit showed \$47.8 billion and \$.2 billion for property, plant and equipment disposals and revaluations for fiscal years 2005 and 2004, respectively. However, based on the financial information provided by agencies to Treasury in GFRS, the fiscal year 2004 amount would be \$25.4 billion. The difference would be reclassified from the net amount of all other differences line item on the Reconciliations of Net Operating Cost and Unified Budget Deficit.
- Treasury did not have an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. For example, we found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury submitted a proposal to the Federal Accounting Standards Advisory Board (FASAB) seeking to amend previously issued standards and eliminate or lessen the disclosure requirements for the consolidated financial statements so that GAAP would no longer require certain of the information that Treasury has not been reporting. An exposure draft of a proposed FASAB standard, based on the Treasury proposal, is currently out for comment. Treasury stated that it is waiting for FASAB approval and issuance of this proposed standard to determine the disclosures that will be required in future consolidated financial statements. As a result of Treasury not providing us with adequate documentation of its rationale for excluding the currently required information and certain of the material deficiencies noted above, we were unable again to determine if the missing information was material to the consolidated financial statements.
- Information system weaknesses existed within the segments of GFRS that were used during the fiscal years 2005 and 2004 reporting processes. We found that the GFRS database (1) was not configured to prevent the alteration of data submitted by federal agencies and (2) was used for both production and testing during the reporting processes. Therefore, information submitted by federal agencies within GFRS is not adequately protected against unauthorized modification or loss. In addition, Treasury was unable to explain why numerous GFRS users appeared to have inappropriate access with GFRS agency information or demonstrate the appropriate segregation of duties exist.
- Although Treasury made progress in addressing them, certain other internal control weaknesses in its process for preparing the consolidated financial statements continued to exist and involved a lack of (1) appropriate documentation of certain

policies and procedures for preparing the consolidated financial statements, (2) adequate supporting documentation for certain adjustments made to the consolidated financial statements, and (3) necessary management reviews.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, there are undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.
- Treasury did not have the infrastructure to address the magnitude of the fiscal year 2005 financial reporting challenges it was faced with, such as an incomplete financial reporting system, compressed time frames for compiling the financial information, and lack of adequate internal control over the financial statement preparation process. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to ensure reliable financial reporting by the reporting date.
- Treasury, in coordination with OMB, had not provided us with adequate documentation evidencing an executable plan of action and milestones for short-term and long range solutions for certain internal control weaknesses we have previously reported regarding the process for preparing the consolidated financial statements.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

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

regarding reconciliations of intragovernmental activity and balances. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Net Outlays—A Component of the Budget Deficit

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

The federal government reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance) and the Reconciliations of Net Operating Cost and Unified Budget Deficit (Reconciliation Statement) budget deficits for fiscal years 2005 and 2004 of \$318.5 billion and \$412.3 billion, respectively. The budget deficit is calculated by subtracting actual budget outlays from actual budget receipts.²⁶ As we have reported since fiscal year 2003, we found material unreconciled differences between the total net outlays reported in selected federal agencies' SBRs and Treasury's central accounting records, which it uses to prepare the Statement of Changes in Cash Balance. Treasury's processes for preparing the Statement of Changes in Cash Balance do not include procedures for identifying and resolving differences between its central accounting records and net outlay amounts reported in agencies' SBRs.

In fiscal year 2004, we noted reported internal control weaknesses regarding certain agencies' SBRs. In fiscal year 2005, several agencies' auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting and reporting of budgetary transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses transcend to agencies' ability to also report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its

²⁶ In previous years, the Statement of Changes in Cash Balance reported actual budget outlays and actual budget receipts; however, beginning in fiscal year 2004, the federal government chose not to disclose budget outlays and budget receipts in this financial statement and only included the budget deficit. Receipts and net outlays (unified budget amounts) are also reported in governmentwide reports—specifically, in the President's Budget (annually); Treasury's Final Monthly Treasury Statement, as part of leading economic indicators on federal finances (quarterly); and Treasury's annual *Combined Statement of Receipts, Outlays, and Balances of the United States Government*.

Combined Statement of Receipts, Outlays, and Balances,²⁷ and certain amounts reported in the President's Budget.

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

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

²⁷Treasury's *Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.

APPENDIX III

Other Material Weaknesses

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

Loans Receivable and Loan Guarantee Liabilities

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

Improper Payments

While agencies have made progress in implementing processes and controls to identify, estimate, and reduce improper payments,²⁸ such improper payments are a longstanding, widespread, and significant problem in the federal government. Congress acknowledged this problem by passing the Improper Payment Information Act (IPIA)²⁹ in 2002. The IPIA requires agencies to review all programs and activities, identify those that may be susceptible to significant improper payments,³⁰ estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments. Further, in fiscal year 2005, OMB began to separately track the elimination of improper payments under the President's Management Agenda.

²⁸Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.

²⁹Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

³⁰OMB defines the term "significant improper payments" as "annual erroneous payments in the program exceeding both 2.5 percent of program payments and \$10 million."

Significant challenges remain to effectively achieve the goals of the IPIA. From our review of agencies' fiscal year 2005 Performance and Accountability Reports (PARs), we noted that some agencies still have not instituted a systematic method of reviewing all programs and activities, have not identified all programs susceptible to significant improper payments, and/or have not annually estimated improper payments for its high risk programs. For example, 7 major agency programs with outlays totaling about \$280 billion, including Medicaid and the Temporary Assistance For Needy Families programs, still cannot annually estimate improper payments, even though they were required by OMB to report such information beginning with their fiscal year 2003 budget submissions. In addition, two agency auditors that tested compliance with IPIA cited agency noncompliance with the act in their annual audit reports.

Federal agencies' estimates of improper payments, based on available information, for fiscal year 2005 exceeded \$38 billion, a net decrease of about \$7 billion, or 16 percent, from the prior year improper payment estimate of \$45 billion.³¹ This decrease was attributable to the following factors. In fiscal year 2005, the Department of Health and Human Services reported a \$9.6 billion decrease in its Medicare program improper payment estimate, principally due to improvements in its due diligence with providers to ensure the necessary documentation is in place to support payment claims. However, in fiscal year 2005, this decrease was partially offset as a result of more programs reporting estimates of improper payments.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced with hearings on Federal Information Security Management Act of 2002³² implementation and information security. In addition, the administration has taken important actions to improve information security, such as revising agency internal control requirements in OMB Circular A-123³³ and issuing extensive guidance on information security.

³¹In their fiscal year 2005 PARs, selected agencies updated their fiscal year 2004 improper payment estimates to reflect changes since issuance of their fiscal year 2004 PARs. These updates increased the governmentwide improper payment estimate for fiscal year 2004 from \$45 billion to \$46 billion.

³²Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).

³³OMB Circular No. A-123, *Management's Responsibility for Internal Control*, (Revised December 21, 2004).

Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities,³⁴ an issue that has been reported in our financial statement audit reports for the past 8 years. Due to errors and delays in recording taxpayer information, payments, and other activities, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

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

(198319)

³⁴GAO, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements*, GAO-06-137 (Washington, D.C.: Nov. 10, 2005).