G A O
Accountability * Integrity * Reliability

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, 2006 and 2005,[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) [3] are met; and (3) complying with significant laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies are responsible for implementing and maintaining financial management systems that substantially comply with Federal Financial Management Improvement Act of 1996 (FFMIA)[4] requirements. Our objective was to audit the consolidated financial statements for the fiscal years ended September 30, 2006 and 2005. Appendix I discusses the scope and methodology of our work.

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[1]The 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.
[2]The consolidated financial statements for the fiscal years ended September 30, 2006 and 2005 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, Balance Sheets, and as of January 1, 2006, the Statement of Social Insurance, including the related notes to these financial statements.
[3]31 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 the Congress on the adequacy of their internal control and accounting systems and on actions to correct significant problems.
[4]31 U.S.C. 3512 note (Federal Financial Management Improvement Act).

A significant number of material weaknesses[5] 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:

- Certain material weaknesses in 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 consolidated financial statements for the fiscal years ended September 30, 2006 and 2005.[6]

- The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2006.

- Our work to test compliance with selected provisions of significant laws and regulations in fiscal year 2006 was limited by the material weaknesses and scope limitations discussed in 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 2006 and 2005, principally resulting from certain material weaknesses, 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 these limitations, readers are cautioned that amounts reported in the consolidated financial statements and related notes may not be reliable. These material weaknesses and other 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.

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[5]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

[6]We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2005.

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 *2006 Financial Report of the United States Government (Financial Report)*.

In fiscal year 2006, the federal government adopted the following new federal accounting standards, as discussed in the notes:

- accounting for and reporting of earmarked funds[7] (Notes 1 and 20),
- reporting heritage assets and stewardship land[8] (Notes 1, 24, and 25),
- changes in disclosure of certain information in the consolidated financial statements[9] (Note 1), and
- presentation of the Statement of Social Insurance (SOSI) as a basic financial statement[10] (Notes 1 and 23).

The SOSI presents the actuarial present value of the federal government's estimated future revenue to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants, using a projection period sufficient to illustrate the long-term sustainability of the social insurance programs. In preparing the SOSI, 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 SOSI and the fact that such assumptions are inherently subject to substantial uncertainty (arising from the likelihood of future changes in general economic, regulatory, and market conditions, as well as other more specific future events, significant uncertainties, and contingencies), there will be differences between the estimates in the SOSI 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 (SMI) Part D projections have an added uncertainty in that they were prepared using very little program experience upon which to base the estimates and the SMI Part B projections assume significant reductions in physician payments, as required under current law, which may or may not occur. The Congress has overridden scheduled reductions in physician payments for each of the last 4 years and recently passed legislation to override scheduled reductions for

[7]Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) 27, *Identifying and Reporting Earmarked Funds* (Washington, D.C.: Dec. 28, 2004).
[8]SFFAS 29, *Heritage Assets and Stewardship Land* (Washington, D.C.: June 7, 2005).
[9]SFFAS 32, *Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"* (Washington, D.C.: Sept. 28, 2006).
[10]SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment* (July 2003), and SFFAS 26, *Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25* (Washington, D.C.: Oct. 29, 2004).

2007.[11] It is not possible to anticipate what other actions the Congress might take, either in the near or long-term, to alter the scheduled reductions in physician payments. If scheduled reductions continue to be overridden in the future, actual SMI Part B expenditures could be materially more than the amounts presented in the SOSI.

Significant Matters of Emphasis

Before discussing the material weaknesses that contributed to our disclaimer of opinion and the additional limitations on the scope of our work we identified, two significant matters require emphasis—the nation's fiscal imbalance and restatements to the fiscal year 2005 consolidated financial statements.

The Nation's Fiscal Imbalance

While we are unable to express an opinion on the U.S. government's consolidated financial statements, the following 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 *2006 Financial Report of the United States Government* into context. Despite improvement in both the fiscal year 2006 reported net operating cost and the cash-based budget deficit, the U.S. government's total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total approximately $50 trillion, representing approximately four times the Nation's total output (GDP) in fiscal year 2006, up from about $20 trillion, or two times GDP in fiscal year 2000. As this 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.

Restatements to the Consolidated Financial Statements

As discussed in Notes 4, 6, 17, and 26, the federal government restated certain of its fiscal year 2005 consolidated financial statements to correct errors. Restatements relating to property, plant, and equipment resulted from misstatements by the Department of Defense, which had received a disclaimer on its originally issued as well as its restated fiscal year 2005 financial statements. Certain other restatements that were made to the consolidated financial statements related to errors that occurred during the preparation of the fiscal year 2005 Reconciliation of Net Operating Cost and Unified Budget Deficit. Because of the material weaknesses over property, plant, and equipment and over the preparation of the consolidated financial statements discussed in this report, the restated amounts may not be reliable.

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[11]The Tax Relief and Health Care Act of 2006, H.R. 6111, 109th Cong. As of December 12, 2006, the President had not signed the legislation.

Limitations on the Scope of Our Work

For fiscal years 2006 and 2005, there were limitations on the scope of our work in addition to the material weaknesses that contributed to our disclaimer of opinion. First, Treasury and OMB depend on certain federal agencies' representations 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 consolidated financial statements primarily because of insufficient representations provided to them by two CFO Act agencies. Second, Treasury was unable to provide the final consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures related to the compilation of these financial statements.

Material Weaknesses Contributing to Our Disclaimer of Opinion

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. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion. Appendix II describes the material weaknesses 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. The material weaknesses that contributed to our disclaimer of opinion 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;

- adequately account for and reconcile intragovernmental activity and balances between federal agencies;

- ensure that the federal government's consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) balanced, and (3) in conformity with GAAP; and

- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of

Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies' financial statements and underlying financial information and records.

Due to the material weaknesses 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, 2006, 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.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found the following four other material weaknesses in internal control as of September 30, 2006. 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 other material weaknesses were the federal government's inability to:

- implement effective credit reform estimation and related financial reporting processes;

- determine the full 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.

Individual federal agency financial statement audit reports identify additional reportable conditions[12] 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 governmentwide level. Also, due to the issues noted throughout this report, additional material weaknesses may exist that have not been reported.

COMPLIANCE WITH SIGNIFICANT LAWS AND REGULATIONS

Our work to test compliance with selected provisions of significant laws and regulations related to financial reporting was limited by the material weaknesses and scope limitations discussed in this report. 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 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 2006, auditors for the majority of the CFO Act agencies reported material weaknesses or other reportable conditions in internal control over financial reporting. The size and complexity of the federal government and the long-standing nature of its financial management systems weaknesses continue to present a formidable management challenge in providing accountability to the nation's taxpayers.

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 2006, auditors for 17 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more

[12]Reportable 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.

of these three FFMIA requirements. 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.

OMB CIRCULAR NO. A-123, *Management's Responsibility for Internal Control*

OMB revised OMB Circular No. A-123, *Management's Responsibility for Internal Control*, which GAO has supported.[13] In fiscal year 2006, agencies began to implement the more rigorous requirements of the revised OMB Circular No. A-123, which include management identification, assessment, testing, correction, and documentation of internal controls over financial reporting for each account or group of accounts, as well as an annual assurance statement from the agency head as to whether internal control over financial reporting is effective.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multi-year implementation plans. OMB stated that it will continue to work with the Chief Financial Officers Council to identify potential areas for additional guidance and share agencies' best practices. It will be important that OMB monitor and oversee federal agencies' implementation of these new requirements.

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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.

David M. Walker
Comptroller General
of the United States

December 1, 2006

[13]See GAO, *Financial Management: Effective Internal Control Is Key to Accountability*, GAO-05-321T (Washington, D.C.: Feb. 16, 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 agencies[14] 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 2002[15] requires most other executive branch agencies to prepare and have audited annual financial statements. The Office of Management and Budget (OMB) and the Department of the Treasury (Treasury) have identified 35 agencies[16] 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 weaknesses that contributed to our disclaimer of opinion and the other material weaknesses affecting internal control that we had previously reported in our report on the consolidated financial statements for fiscal year 2005.[17] 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 2006 and 2005 financial statements. In fiscal years 2006 and 2005, IRS collected about $2.5 trillion and $2.3 trillion, respectively, in tax payments and paid about $277 billion and $267 billion, respectively, in refunds to taxpayers.[18] In fiscal year 2006, 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, 2006 and 2005.[19] The schedules reported for these 2 fiscal years

[14]31 U.S.C. 901(b), 3521(e). 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.
[15]Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002); see 31 U.S.C. 3515.
[16]See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 agencies.
[17]For our report on the U.S. government's consolidated financial statements for fiscal year 2005, see U.S. Department of the Treasury, *2005 Financial Report of the United States Government* (Washington, D.C. Dec. 2005), pp. 135-154, which can be found on GAO's Internet site at www.gao.gov.
[18]GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements*, GAO-07-136 (Washington, D.C.: Nov. 9, 2006).
[19]GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2006 and 2005 Schedules of Federal Debt*, GAO-07-127 (Washington, D.C.: Nov. 7, 2006).

(1) approximately $4.8 trillion (2006) and $4.6 trillion (2005) of federal debt held by the public;[20] (2) about $3.7 trillion (2006) and $3.3 trillion (2005) of intragovernmental debt holdings;[21] and (3) about $222 billion (2006) and $181 billion (2005) of interest on federal debt held by the public. We reported that as of September 30, 2006, 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 2006 with selected provisions of significant laws we tested.

- We audited and expressed unqualified opinions on the December 31, 2005 and 2004, 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.[22] We reported that as of December 31, 2005, 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, 2006.

- We audited and expressed unqualified opinions on the fiscal years 2006 and 2005 financial statements of the United States Securities and Exchange Commission (SEC).[23] In fiscal year 2006, we reported that SEC had effective controls over financial reporting and compliance with 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 2006 and 2005 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.[24] In accordance with section 1008 of this act, DOD reported that its fiscal year 2006 financial statements were not completely reliable. DOD cited deficiencies in several areas affecting its financial statements, including, among others,

[20]The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, and foreign governments and central banks.
[21]Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.
[22]GAO, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2005 and 2004 Financial Statements*, GAO-06-146 (Washington, D.C.: March 2, 2006).
[23]GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2006 and 2005,* GAO-07-134 (Washington, D.C.: Nov. 15, 2006).
[24]Pub. L. No. 107-107, §1008, 115 Stat. 1012, 1204 (Dec. 28, 2001).

(1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations; and (5) disbursement activity. DOD also acknowledges that it makes material amounts of unsupported accounting entries.

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 Weaknesses Contributing to Our Disclaimer of Opinion

The continuing material weaknesses 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 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 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 2006 and 2005, 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 Budget of the United States* (hereafter referred to as "the President's budget") concerning obligations and outlays.

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 adequately perform the required reconciliations for fiscal years 2006 and 2005. For these fiscal years, based on trading partner information provided in the Governmentwide Financial Report System (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 as of the end of the fiscal year. After analysis of the "Material Difference Reports" for fiscal year 2006, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses on the CFO Representations. For both fiscal years 2006 and 2005, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, for fiscal year 2006, about 31 percent of the significant agencies identified by Treasury and OMB did not perform the required audit procedures on their intragovernmental trading partner data included in the footnotes to their closing packages.[25] As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is significantly impaired.

OMB recently issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (November 13, 2006), which has also been incorporated in the Treasury Financial Manual.[26] The OMB memorandum added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions by creating the Chief Financial Officers Council's Intragovernmental Dispute Resolution Committee.[27] Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules and continued strong leadership by OMB.

Preparation of Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2006, 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). In addition, as discussed in our scope limitation section of this report, Treasury could not provide the final fiscal year 2006 consolidated financial statements and supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2006 audit, we found the following:[28]

- Treasury showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three

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[25]GFRS uses a closing package methodology that has been developed to capture each federal agency's information and link the agencies' audited financial statements to the governmentwide consolidated financial statements.
[26]Treasury Financial Manual, Bulletin No. 2007-03, *Intragovernmental Business Rules*.
[27]The U.S. Chief Financial Officers Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of the Office of Management and Budget and the Department of the Treasury who work collaboratively to improve financial management in the U.S. Government.
[28]Most of the issues we identified in fiscal year 2006 existed in fiscal year 2005, and many have existed for a number of years. In April 2006, we reported in greater detail on the issues we identified in GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in Preparing the Consolidated Financial Statements of the U.S. Government*, GAO-06-415 (Washington, D.C.: April 21, 2006). This report includes numerous recommendations to Treasury and OMB.

principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.

- To make the fiscal years 2006 and 2005 consolidated financial statements balance, Treasury recorded net decreases of $11 billion and $4.1 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Other - Unmatched transactions and balances."[29] An additional net $10.4 billion and $3.2 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2006 and 2005, 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 fully identify and report items needed to reconcile the operating results, which for fiscal year 2006 showed a net operating cost of $449.5 billion, to the budget results, which for the same period showed a unified budget deficit of $247.7 billion.

- Treasury's elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As previously discussed, amounts reported for federal agency trading partners for certain intragovernmental accounts were significantly out of balance. This resulted in the need for unsupported intragovernmental elimination entries by Treasury in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the consolidated financial statements.

- We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that Treasury had not been reporting.[30] There continued, though, to be other disclosures required by GAAP that are not disclosed in the consolidated financial statements. Treasury has plans to address certain of the omitted disclosures in future years' consolidated financial statements. Because of certain of the material weaknesses noted in this report, we were unable to determine if the omitted information was material to the consolidated financial statements.

[29]Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to operations, it reported this amount as a component of net operating cost in the accompanying consolidated financial statements.
[30]SFFAS No. 32, *Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"* (Washington, D.C.: Sept. 28, 2006).

- Treasury continued to make progress in addressing certain other internal control weaknesses in Treasury's process for preparing the consolidated financial statements. However, internal control weaknesses continued to exist involving 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) effective 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, as we have reported in past years, there continue to be 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.

- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2006 financial reporting challenges it faced, such as (1) GFRS undergoing further development[31] and not yet being fully operational, and (2) weaknesses in Treasury's process for preparing the consolidated financial statements noted above. 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 help ensure reliable financial reporting by the reporting date.

- During fiscal year 2006, Treasury, in coordination with OMB, developed and began implementing corrective action plans 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. Resolving some of these internal control weaknesses will be a difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

<u>Outlays and Receipts—Components of the Budget Deficit</u>

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report the budget deficit for fiscal years 2006 and 2005 of $247.7 billion and $318.6 billion, respectively.[32]

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[31]See GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Effective Implementation of Treasury's Governmentwide Financial Report System at Risk*, GAO-06-413 (Washington, D.C.: April 21, 2006).
[32]The budget deficit, receipts, and outlays amounts are reported in Treasury's Monthly Treasury Statement and the President's Budget.

The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies' Statement of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit[33] reported in the consolidated financial statements. OMB and Treasury have been working with federal agencies to reduce these material unreconciled differences. Such efforts have resulted in significantly reducing the net outlay differences in fiscal year 2006. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury's central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will be unknown.

In fiscal year 2006, we again noted that 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 also affect the agencies' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its *Combined Statement of Receipts, Outlays, and Balances*,[34] and certain amounts reported in the President's Budget.

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[33]See GAO's audit report on its audit of the federal government's fiscal year 2005 financial statements that was incorporated in the *2005 Financial Report of the U.S. Government* published by Treasury. Also, see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).
[34]Treasury'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, 2006. In addition to the material weaknesses discussed in Appendix II that contributed to our disclaimer of opinion, we found the following four other material weaknesses in internal control.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies accounting for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by federal credit agencies, these issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Further, these weaknesses continue to 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.

Improper Payments

Under the leadership of OMB, agencies have continued to make progress in addressing improper payments. Improvements, though, are still needed to fully address the requirements of the Improper Payments Information Act of 2002 (IPIA).[35] Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.[36] The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments,[37] estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments. In addition, OMB has established a program-specific initiative under the President's Management Agenda for 15 federal agencies to hold federal agency managers accountable for meeting the goals of IPIA and to ensure that the necessary attention and resources are dedicated to meeting the IPIA requirements.

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

[36]See GAO, *Improper Payments: Incomplete Reporting under the Improper Payments Information Act Masks the Extent of the Problem,* GAO-07-254T (Washington, D.C.: Dec. 5, 2006).

[37]IPIA defines improper payments 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 service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts. OMB's guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and $10 million annually.

For fiscal year 2006, federal agencies' estimates of improper payments, based on available information, totaled about $42 billion, a net increase of about $4 billion, or an 11 percent increase from the prior year improper payment estimate of $38 billion.[38] This increase was primarily attributable to 10 newly reported programs with improper payment estimates totaling about $2.3 billion and certain federal agencies reporting an increase in estimates for programs that had previously reported.

We found that some agencies have not annually reviewed all programs and activities, have not estimated improper payments for all risk-susceptible programs, or have not estimated improper payments for all components of risk-susceptible programs. For example, we noted that in fiscal year 2006, improper payment estimates were not made for 9 risk-susceptible federal programs, including Medicaid with total program outlays of about $183 billion for fiscal year 2006. Further, we noted some agencies reported noncompliance issues and major management challenges related to IPIA implementation, including the methodologies used to estimate improper payments, adequacy of agency documentation, management oversight, and contract management.

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 by hearings on the implementation of the Federal Information Security Management Act of 2002[39] and information security. In addition, the administration has taken important actions to improve information security, such as requiring agencies in OMB Memorandum M-06-16[40] to perform specific actions to protect certain personally identifiable information and issuing extensive guidance on information security.

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[38]In their fiscal year 2006 Performance and Accountability Reports (PARs), selected federal agencies updated their fiscal year 2005 improper payment estimates to reflect changes since issuance of their fiscal year 2005 PARs. These updates increased the governmentwide improper payment estimate for fiscal year 2005 from $38 billion to $39 billion.
[39]Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).
[40]OMB Memorandum No. M-06-16, *Protection of Sensitive Agency Information* (June 23, 2006).

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,[41] an issue that has been reported in our financial statement audit reports for the past 9 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.

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[41]GAO, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements,* GAO-07-136 (Washington, D.C.: Nov. 9, 2006).