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

During fiscal year 2012, the federal government continued to face economic and fiscal challenges in a slow-growth economy with high unemployment. To operate as effectively and efficiently as possible and to make difficult decisions to address the federal government's fiscal challenges, Congress, the administration, and federal managers must have ready access to reliable and complete financial and performance information—both for individual federal entities and for the federal government as a whole. Even though significant progress has been made since the enactment of key federal financial management reforms in the 1990s, our report on the U.S. government's consolidated financial statements illustrates that much work remains to improve federal financial management. Further improvements are urgently needed.

Our report on the U.S. government's consolidated financial statements is enclosed. In summary, we found the following:

- Certain material weaknesses[1] in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that prevented us from expressing an opinion on the fiscal years 2012 and 2011 accrual-based consolidated financial statements.[2] About 34 percent of the federal government's reported total assets as of September 30, 2012, and approximately 21 percent of the federal government's reported net cost for fiscal year 2012 relate to the Department of Defense (DOD), which received a disclaimer of opinion on its consolidated financial statements.

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[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.
[2]The accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011 consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. Two additional statements that do not interrelate with the accrual-based consolidated financial statements are also included: the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, and related notes.

- Because of significant uncertainties, primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, we are unable to, and we do not, express opinions on the 2012, 2011, and 2010 Statements of Social Insurance, as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts. About $27.2 trillion, or 70.5 percent, of the reported total present value of future expenditures in excess of future revenue presented in the 2012 Statement of Social Insurance relates to Medicare programs reported in the Department of Health and Human Services' 2012 Statement of Social Insurance, which received a disclaimer of opinion.[3]

- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2012.

- Our tests of compliance with selected provisions of laws and regulations for fiscal year 2012 were limited by the material weaknesses and other scope limitations discussed in our report.

While significant progress has been made in improving federal financial management since the federal government began preparing consolidated financial statements 16 years ago, three major impediments continued to prevent us from rendering an opinion on the federal government's accrual-based consolidated financial statements over this period: (1) serious financial management problems at DOD that have prevented its financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements.

It is important to emphasize that the vast majority of the 24 Chief Financial Officers Act agencies received unqualified opinions on their respective entities' financial statements. However, DOD and the Department of Homeland Security (DHS) have consistently been unable to receive such audit opinions. Efforts are under way at both entities to address this situation. At DOD, following years of unsuccessful financial improvement efforts, the DOD Comptroller established the Financial Improvement and Audit Readiness (FIAR) Directorate to develop, manage, and implement a strategic approach for addressing internal control weaknesses and for achieving auditability, and to integrate those efforts with other improvement activities, such as the department's business systems modernization efforts. DOD's current FIAR strategy and methodology focus on two priorities—budgetary information and asset accountability—with an overall goal of preparing auditable departmentwide financial statements by September 30, 2017.[4] Because budgetary information is widely and regularly used for management, one of DOD's highest interim priorities is the improvement of its budgetary information and processes underlying its Statement of Budgetary Resources (SBR). In October 2011, the Secretary of Defense called for a revised plan that would put DOD component

[3]We issued an unqualified opinion on the Statements of Social Insurance for 2009 and 2008.

[4]Section 1003 of the National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84, 123 Stat. 2190, 2439-41 (Oct. 28, 2009), made the development and maintenance of the FIAR Plan a statutory requirement. Under the act, the FIAR Plan must ensure that DOD's financial statements are validated as ready for audit by September 30, 2017. More recently, section 1005 of the National Defense Authorization Act for Fiscal Year 2013, Pub. L. No. 112-239, 126 Stat. 1632 (Jan. 2, 2013), added a new requirement for DOD's FIAR Plan to ensure that one of DOD's financial statements, the Statement of Budgetary Resources, is validated as ready for audit by September 30, 2014.

organizations on a pace to achieve SBR audit readiness by the end of fiscal year 2014, an acceleration of the timeline for most components. In response to the revised plan for the SBR, DOD revised its timelines and actions are under way as reported in FIAR Plan Status Reports. However, according to the November 2012 FIAR Plan Status Report, components are still in the early phases of their actions. Moreover, the results of recent work by us and the DOD Office of Inspector General have raised concerns about the ability of DOD components to implement the FIAR Plan effectively.[5]

With respect to DHS, for the first time, it was able to attain a qualified audit opinion on its departmentwide financial statements. The auditor qualified the audit opinion on DHS's fiscal year 2012 financial statements because of DHS's inability to provide sufficient evidence to support certain components of property, plant, and equipment and heritage and stewardship assets presented in the financial statements. In addition, such limitation in the scope of the audit contributed to the auditor's inability to form an opinion on DHS's internal control over financial reporting. It is important that DHS continue to remediate its internal control deficiencies and build on the progress it has made as it moves forward to achieve its ultimate goal of obtaining clean audit opinions on its fiscal year 2013 financial statements and on its internal control over financial reporting.[6]

Various efforts are also under way to address the other two major impediments. During fiscal year 2012, the Department of the Treasury (Treasury) expanded its ongoing efforts, working with federal entities, to help resolve and eliminate material differences in intragovernmental activity and balances. These efforts included developing and implementing a formalized resolution plan and related corrective actions. In addition, Treasury implemented corrective actions to address certain deficiencies regarding the preparation of the consolidated financial statements, including obtaining and utilizing certain interim financial information from federal entities in preparing initial financial statement drafts. Treasury also began to develop a methodology to reconcile the budget deficit to the consolidated financial statements. Fully addressing the numerous issues in these areas will require a strong and sustained commitment by federal entities and leadership by Treasury and the Office of Management and Budget.

The material weaknesses underlying these three major impediments continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an efficient and effective manner.

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[5]GAO, *DOD Financial Management: Marine Corps Statement of Budgetary Resources Audit Results and Lessons Learned*, GAO-11-830 (Washington, D.C.: Sept. 15, 2011, reissued Oct. 17, 2011), and *DOD Financial Management: Improvement Needed in DOD Components' Implementation of Audit Readiness Effort*, GAO-11-851 (Washington, D.C.: Sept. 13, 2011).

[6]Section 2(b) of the DHS Audit Requirement Target Act of 2012, Pub. L. No. 112-217, 126 Stat. 1591 (Dec. 20, 2012) (DART Act) made obtaining an unqualified audit opinion on DHS's financial statements for fiscal year 2013, and each subsequent fiscal year, a statutory requirement. Under the DART Act, DHS must ensure that its consolidated financial statements for fiscal year 2013, and for each subsequent year, are ready in a timely manner and in preparation for an audit in order to obtain an unqualified opinion on the full set of financial statements.

In addition to the material weaknesses referred to above, we identified four other material weaknesses. These are the federal government's inability to (1) determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments, (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, (3) effectively manage its tax collection activities, and (4) effectively monitor and report loans receivable and loan guarantee liabilities. Additional details concerning these material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations are presented in our report. Until the problems outlined in our report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

The last economic recession and the federal government's actions to stabilize financial markets and promote economic recovery, among other factors, continued to significantly affect the federal government's financial condition. The federal government reported a net operating cost of about $1.3 trillion and a unified budget deficit of approximately $1.1 trillion for fiscal year 2012, and as of September 30, 2012, debt held by the public had increased to 73 percent of gross domestic product (GDP). As of September 30, 2012, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in reported federal government assets of over $152 billion (reported net of about $109 billion in valuation losses), and certain reported liabilities. The ultimate cost of the federal government's actions to stabilize the financial markets and promote economic recovery will not be known for some time as uncertainties related to the valuation of these assets and liabilities are resolved and further federal government actions are taken in fiscal year 2013 and later. While the federal government has significantly reduced assets and liabilities related to its actions to stabilize the financial markets and promote economic recovery, it faces the challenge of determining the most expeditious manner in which to bring closure to its remaining initiatives in these areas while optimizing its investment returns.

Because the valuation of these and certain other assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions, actual results may be materially different from the reported amounts. Examples of assets and liabilities reported by the federal government that are subject to substantial uncertainty include the following:

- The federal government's consolidated financial statements as of September 30, 2012, include approximately $109 billion of investments in two government-sponsored enterprises—the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) (reported net of about $85 billion in valuation losses). In addition, as of September 30, 2012, the financial statements include about $9 billion of liabilities for future payments to Fannie Mae and Freddie Mac and disclose a projected maximum remaining potential commitment to these entities of about $282 billion under agreements between Treasury and the entities. The future structures of these two government-sponsored enterprises and the roles they will serve in the mortgage market must still be determined.

- The federal government reported Troubled Asset Relief Program (TARP) direct loans and equity investments of approximately $40 billion as of September 30, 2012 (reported net of about $23 billion in valuation losses), of which approximately $20 billion related to loans to and equity investments in certain entities in the automotive industry.

- The federal government reported that the Pension Benefit Guaranty Corporation's (PBGC) liabilities exceeded its assets by about $34 billion as of September 30, 2012. PBGC is subject to further losses if plan terminations that are reasonably possible occur.

There are risks that other factors could affect the federal government's financial condition in the future, including the following:

- The U.S. Postal Service (USPS) is facing a deteriorating financial situation as it reached its borrowing limit of $15 billion in fiscal year 2012 and finished the year with a reported net loss of almost $16 billion.

- The Federal Housing Administration (FHA) reported that its liabilities exceeded its assets by about $15 billion as of September 30, 2012, and that the capital ratio for its Mutual Mortgage Insurance Fund fell below zero during the fiscal year. In addition, the ultimate roles of Fannie Mae and Freddie Mac in the mortgage market may further affect FHA's financial condition.

- Several initiatives undertaken during the last 4 years by the Board of Governors of the Federal Reserve System to stabilize the financial markets have led to a significant change in the composition and size of reported securities on the Federal Reserve's balance sheet. The value of these securities, which include mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association, is subject to interest rate risk and may decline or increase depending on interest rate changes. Therefore, if the Federal Reserve sells these securities at a loss, future payments of Federal Reserve earnings to the federal government may be reduced.[7]

GAO's High-Risk list includes some of the issues discussed above such as information security, USPS and DOD financial management, and the PBGC insurance program.[8] Every 2 years, GAO provides Congress with an update on its High-Risk series, which highlights federal entities and program areas that are high risk due to their vulnerabilities to fraud, waste, abuse, and mismanagement or are most in need of broad reform. We plan to update our High-Risk series in early 2013.

Increased attention to risks that could affect the federal government's financial condition is made more important because of the nation's longer-term fiscal challenges. The comprehensive long-term fiscal projections presented in the unaudited Required Supplementary Information section of the *2012 Financial Report of the United States*

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[7]Under Federal Reserve System policy, excess Federal Reserve Bank earnings are paid to the federal government. The federal government reported such net earnings of about $82 billion for fiscal year 2012, still well above its historical levels.
[8]GAO, *High-Risk Series: An Update*, GAO-11-278 (Washington, D.C.: February 2011).

Government (*2012 Financial Report*) show that—absent policy changes—the federal government continues to face an unsustainable fiscal path. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare benefits. Under these projections, spending for the major health and retirement programs will increase in coming decades as more members of the baby-boom generation become eligible for benefits and the health care cost for each enrollee increases. Over the long term, the structural imbalance between spending and revenue will lead to continued growth of debt held by the public as a share of GDP; this means the current structure of the federal budget is unsustainable.

These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. If, however, the cost containment measures are not sustained over the long term—a concern expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow much more rapidly. GAO also prepares long-term federal fiscal simulations, which continue to show debt rising as a share of GDP.[9] Under GAO's Alternative simulation,[10] which uses the CMS Office of the Actuary's alternative health care cost projections, future spending in excess of receipts would be greater and debt held by the public as a share of GDP would grow more quickly than the projections in the *2012 Financial Report*.

In January 2013, the American Taxpayer Relief Act of 2012[11] was enacted, which affected taxes and made some changes to the Budget Control Act of 2011.[12] Congress will be considering further legislative changes to address the fiscal challenges.

Reliable financial and performance information is even more critical as (1) federal managers likely face increasingly tight budget constraints and need to operate their respective entities as efficiently and effectively as possible and (2) decision makers carry out the important task of deciding how to use multiple tools (tax provisions, discretionary spending, mandatory spending, and credit programs) to address the federal government's fiscal challenges.

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

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

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

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

On December 26, 2012, the Secretary of the Treasury notified Congress that, on December 31, 2012, the federal government would reach its debt limit.[13] On December 31, 2012, Treasury began deviating from its normal debt management operations and taking a number of actions, referred to by Treasury as extraordinary actions, to avoid exceeding the debt limit. As of the date of our audit report, the debt limit has not been increased. As we have previously reported, the debt limit does not restrict Congress's ability to enact spending and revenue legislation that affects the level of debt or otherwise constrains fiscal policy; it restricts Treasury's authority to borrow to finance the decisions already enacted by Congress and the President.[14] The United States benefits from the confidence investors have that debt backed by the full faith and credit of the United States will be honored. As we have also previously reported, delays in raising the debt limit can create uncertainty in the Treasury market and lead to higher Treasury borrowing costs. We estimated, as reported in July 2012, that delays in raising the debt limit in 2011 led to an increase in Treasury's borrowing costs of about $1.3 billion in fiscal year 2011. However, this does not account for the multiyear effects on increased costs for Treasury securities that will remain outstanding after fiscal year 2011. In both our February 2011 and July 2012 reports, we noted that Congress should consider ways to better link decisions about the debt limit with decisions about spending and revenue to avoid potential disruptions to the Treasury market and to help inform the fiscal policy debate in a timely way.

Our report on the U.S. government's consolidated financial statements would not be possible without the commitment and professionalism of inspectors general throughout the federal government who are responsible for annually auditing the financial statements of individual federal entities. We also appreciate the cooperation and assistance of Department of the Treasury and Office of Management and Budget officials as well as the federal entities' chief financial officers. We look forward to continuing to work with these individuals, the administration, and Congress to achieve the goals and objectives of federal financial management reform.

Our report begins on page 223. Our guide[15] to the *Financial Report of the United States Government* is intended to help those who seek to obtain a better understanding of the *Financial Report* and is available on GAO's website at www.gao.gov. In addition, the website includes a guide[16] to understanding the differences between accrual and cash

[13]Congress and the President have enacted laws to establish a limit on the amount of federal debt that can be outstanding at one time, referred to as the debt limit. The debt limit is codified at 31 U.S.C. §§ 3101 and 3101A.

[14]GAO, *Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs*, GAO-12-701 (Washington, D.C.: July 23, 2012), and *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, GAO-11-203 (Washington, D.C.: Feb. 22, 2011).

[15]GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-946SP (Washington, D.C.: September 2009).

[16]See http://www.gao.gov/special.pubs/longterm/deficit/, which is based on information in GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006). In January 2007 and 2008, we issued updates to this guide for fiscal years 2006 and 2007; see GAO-07-341SP (Washington, D.C.: January 2007) and GAO-08-410SP (Washington, D.C.: January 2008).

measures of the deficit and provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.

Our report was prepared under the direction of Robert F. Dacey, Chief Accountant, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-3406.

Gene L. Dodaro
Comptroller General
of the United States

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

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