

GAO

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Government Management, Organization,
and Procurement, Committee on
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**U.S. GOVERNMENT
FINANCIAL STATEMENTS**

**Fiscal Year 2009 Audit
Highlights Financial
Management Challenges
and Unsustainable Long-
Term Fiscal Path**

Statement of Gene L. Dodaro
Acting Comptroller General of the United States



GAO

Accountability * Integrity * Reliability



Highlights of [GAO-10-483T](#), a testimony before the subcommittee on Government Management, Organization, and Procurement, Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

GAO annually audits the consolidated financial statements of the U.S. government (CFS). Congress and the President need reliable, useful, and timely financial and performance information to make sound decisions and conduct effective oversight of federal government programs and policies.

The federal government began preparing the CFS 13 years ago. Over the years, certain material weaknesses in internal control over financial reporting have prevented GAO from expressing an opinion on the accrual-based consolidated financial statements. Unless these weaknesses are adequately addressed, they will, among other things, continue to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (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.

This testimony presents the results of GAO's audit of the CFS for fiscal year 2009 and discusses certain of the federal government's significant near- and long-term fiscal challenges.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management. The federal government has generally taken or plans to take actions to address our recommendations.

View [GAO-10-483T](#) or [key components](#). For more information, contact Jeanette M. Franzel or Gary T. Engel at (202) 512-2600 or Susan J. Irving at (202) 512-6806.

U.S. GOVERNMENT FINANCIAL STATEMENTS

Fiscal Year 2009 Audit Highlights Financial Management Challenges and Unsustainable Long-Term Fiscal Path

What GAO Found

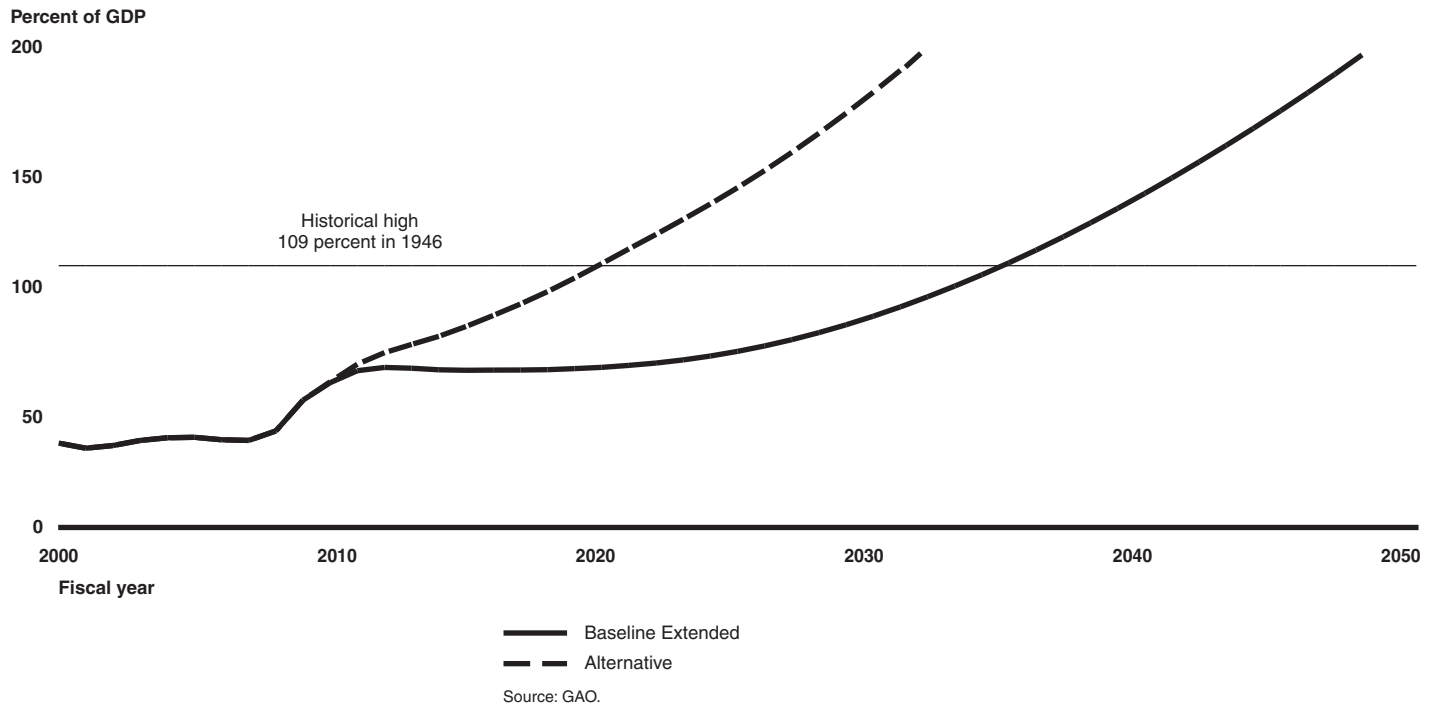
For the third consecutive year, GAO rendered an unqualified opinion on the Statement of Social Insurance (SOSI). Given the importance of social insurance programs like Medicare and Social Security to the federal government's long-term fiscal outlook, the SOSI is critical to understanding the federal government's financial condition and fiscal sustainability. Three major impediments continued to prevent GAO from rendering an opinion on the federal government's consolidated financial statements other than the SOSI: (1) serious financial management problems at the Department of Defense, (2) federal entities' inability to adequately account for and reconcile intragovernmental activity and balances, and (3) an ineffective process for preparing the consolidated financial statements. In addition to the material weaknesses underlying these major impediments, GAO noted material weaknesses involving improper payments estimated to be at least \$98 billion for fiscal year 2009, information security, and tax collection activities.

The recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery have significantly affected the federal government's financial condition. The resulting substantial investments and increases in liabilities, net operating cost, the unified budget deficit, and debt held by the public are reported in the U.S. government's consolidated financial statements for fiscal year 2009. The ultimate cost of these actions and their impact on the federal government's financial condition will not be known for some time in part because the valuation of these assets and liabilities is based on assumptions and estimates that are inherently uncertain. Looking ahead, the federal government will need to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. In addition, problems in the nation's financial sector have exposed serious weaknesses in the current U.S. financial regulatory system. If those weaknesses are not adequately addressed, we could see similar or even worse crises in the future. Consequently, meaningful financial regulatory reform is of utmost concern.

The federal government faces a long-term fiscal challenge resulting from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. GAO prepares long-term fiscal simulations that include projections of revenue and expenditures for all federal programs. As a result, these simulations present a comprehensive analysis of the sustainability of the federal government's long-term fiscal outlook. Many of the pressures highlighted in GAO's simulations, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have previously served to reduce the unified budget deficit; however, the Congressional Budget Office recently estimated

that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees' estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the federal budget. As shown in the figure, absent a change in policy, federal debt held by the public as a share of gross domestic product (GDP) could exceed the historical high reached in the aftermath of World War II by 2020—10 years sooner than GAO's simulation showed just 2 years ago. Although the economy is still fragile, there is wide agreement on the need to begin to change the long-term fiscal path as soon as possible without slowing the recovery because the magnitude of the changes required grows with time. Consequently, the administration and Congress will need to apply the same level of intensity to the nation's long-term fiscal challenge as they have to the recent economic and financial market issues. Congress recently enacted a return to statutory PAYGO and, in February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio. In addition, comprehensive long-term fiscal projections will be required in the federal government's financial statements beginning in fiscal year 2010, under a new accounting standard.

Debt Held by the Public Under Two Fiscal Policy Simulations



Madam Chairwoman, Ranking Member Bilbray and Other Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2009 and 2008. Given the federal government's near- and long-term fiscal challenges, the need for transparency and for Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information is greater than ever. As our report illustrates, however, even though certain progress has been made, much work remains to improve federal financial management. Consequently, financial management needs to be a top priority of this administration and Congress. I would like to commend you, Madam Chairwoman, and this Subcommittee, for continuing the annual tradition of oversight hearings on this important subject. Your involvement is critical to assuring progress.

Our testimony today discusses (1) the major issues relating to the consolidated financial statements for fiscal years 2009 and 2008, including continued major impediments to an opinion on the consolidated financial statements other than the Statement of Social Insurance;¹ (2) the impacts of the economic recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery on the federal government's financial condition; and (3) challenges posed by the federal government's current long-term fiscal outlook. Our audit was conducted in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.²

¹The consolidated financial statements other than the Statement of Social Insurance are referred to as the accrual-based consolidated financial statements. Most revenues reported in these financial statements are recorded on a modified cash basis.

²Our work on the long-term fiscal outlook was conducted in accordance with all sections of GAO's Quality Assurance Framework that were relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

Both the consolidated financial statements and our related audit report are included in the fiscal year 2009 *Financial Report of the United States Government (Financial Report)*. Our audit report 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 agencies. The *Financial Report* was issued by the Department of the Treasury (Treasury) on February 26, 2010.³ This report is available through GAO's Internet site, at <http://www.gao.gov/financial/fy2009financialreport.html> and Treasury's Internet site, at <http://www.fms.treas.gov/fr/index.html>.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2009 and 2008

Since the enactment of key financial management reforms in the 1990s, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix I, 20 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their fiscal year 2009 financial statements. In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. Also, accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. Further, we were able to render unqualified opinions on the 2009, 2008, and 2007 Statements of Social Insurance.⁴ Given the importance of social insurance programs like Medicare and Social Security to the federal government's long-term fiscal outlook, the Statement of Social Insurance is critical to understanding the federal government's financial condition and fiscal sustainability.

Although this progress is commendable, the federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain significant information reported in the U.S. government's accrual-based consolidated financial statements. Underlying material weaknesses

³Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, [GAO-05-958SP](#) (Washington, D.C.: September 2005). In September 2009, we issued an update to this guide to reflect recent changes to the federal accounting standards and resulting changes to the *Financial Report*; see [GAO-09-946SP](#) (Washington, D.C.: September 2009).

⁴We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance. Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

in internal control,⁵ which generally have existed for years,⁶ contributed to our disclaimer of opinion on the U.S. government's accrual-based consolidated financial statements for the fiscal years ended 2009 and 2008.⁷ Those material weaknesses relate to the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the accrual-based consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain federal entities;
- adequately account for and reconcile intragovernmental activity and balances between federal entities;
- ensure that the federal government's accrual-based consolidated financial statements were (1) consistent with the underlying audited entities' financial statements, (2) properly balanced, and (3) in conformity with U.S. generally accepted accounting principles (GAAP); and
- identify and either resolve or explain material differences between certain components of the budget deficit reported in Treasury's records, which are used to prepare the Reconciliation of Net Operating

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

⁶We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2006 and on the accrual-based consolidated financial statements of the U.S. government for fiscal years 2007 and 2008.

⁷A more detailed description of the material weaknesses that contributed to our disclaimer of opinion, including the primary effects of these material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 224 through 230 of the *Financial Report*.

Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal entities' financial statements and underlying financial information and records.

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, we found three other material weaknesses in internal control.⁸ These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments,⁹
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

The material weaknesses discussed in our audit report 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.

Also, many of the CFO Act agencies continue to struggle with financial systems that are not integrated and do not meet the needs of management for reliable, useful, and timely financial information. Often, agencies expend major time, effort, and resources to develop information that their systems should be able to provide on a daily or recurring basis.

⁸A more detailed discussion of these weaknesses, including the primary effects of the material weaknesses on the accrual-based consolidated financial statements and on the management of federal government operations, can be found on pages 231 through 233 of the *Financial Report*.

⁹Federal entities reported estimates of improper payment amounts that totaled \$98.7 billion for fiscal year 2009, which represented about 5 percent of \$1.9 trillion of reported outlays for the related programs.

Addressing Impediments to an Opinion on the Accrual-Based Consolidated Financial Statements

Three major impediments continued to prevent us from rendering an opinion on the U.S. government's accrual-based consolidated financial statements: (1) serious financial management problems at DOD that have prevented DOD's financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Additional impediments, such as certain entities' fiscal year 2009 financial statements that, as of the date of our audit report, received disclaimers of opinion or were not audited, also contributed to our inability to render an opinion on the U.S. government's accrual-based consolidated financial statements. Extensive efforts by DOD and other entity officials and cooperative efforts between entity chief financial officers, Treasury officials, and Office of Management and Budget (OMB) officials will be needed to resolve these obstacles to achieving an opinion on the U.S. government's accrual-based consolidated financial statements.

Improving Financial Management at DOD

Given DOD's significant size and complexity, the resolution of its serious financial management problems is an essential element in further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements. Reported weaknesses in DOD's financial management and other business operations adversely affect the reliability of DOD's financial data; the economy, efficiency, and effectiveness of its operations; and its ability to produce auditable financial statements. DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement.¹⁰ Eight of the high-risk areas are specific to DOD and include DOD's overall approach to business transformation, and financial and contract management.

To effectively transform its business operations, DOD management must have reliable financial information. Without it, DOD is severely hampered in its ability to make sound budgetary and programmatic decisions, monitor trends, make adjustments to improve performance, reduce operating costs, or maximize the use of resources.¹¹

¹⁰GAO, *High-Risk Series: An Update*, [GAO-09-271](#) (Washington, D.C.: January 2009).

¹¹Gene L. Dodaro, "Maximizing DOD's Potential to Face New Fiscal Challenges and Strengthen Interagency Partnerships." Presented before the National Defense University, Washington, D.C., January 6, 2010.

DOD continues to take steps toward addressing the department's long-standing financial management weaknesses. The current DOD Comptroller's focus on improving the department's budgetary information and asset accountability will result in a change in emphasis within the Financial Improvement and Audit Readiness (FIAR) Plan, DOD's plan for improving its financial management. The emphasis is now on two areas—first, strengthening information and processes supporting the department's Statements of Budgetary Resources; and second, improving the accuracy and reliability of management information pertaining to the department's mission-critical assets, including weapons systems, real property, and general equipment, and validating improvement through existence and completeness testing.

Budgetary and asset-accountability information is widely used by DOD managers at all levels. As such, its reliability is vital to daily operations and management. In this regard, the Marine Corps recently began an audit of its fiscal year 2010 Statement of Budgetary Resources. DOD intends to share with the other services the approaches and lessons learned from the Marine Corps audit.

A concentrated focus such as the DOD Comptroller's emphasis on budget and asset information may increase the department's ability to show incremental progress toward achieving auditability in the short term. In response to GAO's recommendations, the department has also put in place a process to improve standardization and comparability of financial management improvement efforts among the military services. The success of this process will depend on top management support and oversight, as well as high-quality planning and effective implementation at all levels.

The National Defense Authorization Act for Fiscal Year 2010 (NDAA)¹² lists corrective and improvement actions that DOD is required to take in developing and implementing the FIAR Plan. Consistent with recommendations we made in May 2009 regarding DOD's FIAR Plan,¹³ the NDAA requires DOD to

¹²Pub. L. No. 111-84, Div. A, title X § 1003, 123 Stat. 2190, 2439-2441 (Oct. 28, 2009).

¹³GAO, *Financial Management: Achieving Financial Statement Auditability in the Department of Defense*, [GAO-09-373](#) (Washington, D.C.: May 6, 2009).

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- develop standardized guidance for financial improvement plans by components of the department;
 - establish a baseline of financial management capabilities and weaknesses at the component level;
 - provide results-oriented metrics for measuring and reporting quantifiable results toward addressing financial management deficiencies;
 - define the oversight roles of the Chief Management Officer (CMO) of the department, the CMOs of the military services, and other appropriate elements of the department to ensure that the FIAR requirements are carried out;
 - assign to appropriate officials and organizations at the component level accountability for carrying out specific elements of the FIAR Plan;
 - develop mechanisms to track budgets and expenditures for implementation of the FIAR requirements; and
 - develop a mechanism to conduct audits of the military intelligence programs and agencies and submit the audited financial statements to Congress in a classified manner.

We are encouraged by continuing congressional oversight of DOD's business transformation and financial management improvement efforts and the commitment of DOD's leaders to implementing sustained improvements in the department's ability to produce reliable, useful, and timely information for decision making and reporting. We will continue to monitor DOD's progress in addressing its financial management weaknesses and transforming its business operations. As part of this effort, we are also monitoring DOD's specific actions to achieve financial statement auditability for its components.

Reconciling Intragovernmental Activity and Balances

Federal entities are unable to adequately account for and reconcile intragovernmental activity and balances. For both fiscal years 2009 and 2008, amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. Although OMB and Treasury require the CFOs of 35 federal entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners, a substantial number of the entities did not adequately perform those reconciliations for fiscal years 2009 and 2008.

In addition, these entities are required to report to Treasury, the entity's inspector general, and GAO on the extent and results of intragovernmental activity and balance-reconciliation efforts as of the end of the fiscal year. A significant number of CFOs were unable to adequately explain or support

the material differences with their trading partners. Many cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication as to when the differences would be resolved. As a result of these circumstances, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

GAO has identified and reported on numerous intragovernmental activities and balances issues and has made several recommendations to Treasury and OMB to address those issues. Treasury and OMB have generally taken or plan to take actions to address these recommendations. Treasury continues to take steps to help resolve material differences in intragovernmental activity and balances. For example, beginning in the third quarter of 2009, Treasury required entities to perform additional reconciliations related to certain intragovernmental appropriations and transfer activity. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal entities to fully implement guidance regarding business rules for intragovernmental transactions issued by OMB and Treasury as well as continued strong leadership by OMB and Treasury.¹⁴

Preparing the Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2009, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with GAAP.¹⁵ For example,

¹⁴In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions.

¹⁵Most of the issues we identified in fiscal year 2009 existed in fiscal year 2008, and many have existed for a number of years. In April 2009, we reported the issues we identified to Treasury and OMB and provided recommendations for corrective action in GAO, *Financial Audit: Material Weaknesses in Internal Control Continue to Impact Preparation of the Consolidated Financial Statements on the U.S. Government*, [GAO-09-387](#) (Washington, D.C.: Apr. 21, 2009). We also reported that as of December 9, 2008, the date of our report on our audit of the fiscal year 2008 consolidated financial statements, 16 of the 56 open recommendations from the previous years' audits had been closed.

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- Treasury’s process did not ensure that the information in the Statement of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Unified Budget Deficit, and Statements of Changes in Cash Balance from Unified Budget and Other Activities was fully consistent with the underlying information in federal entities’ audited financial statements and other financial data.
 - To make the fiscal years 2009 and 2008 consolidated financial statements balance, Treasury recorded net increases of \$17.4 billion and \$29.8 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled “Unmatched transactions and balances.”¹⁶ An additional net \$8 billion and \$11 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2009 and 2008, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
 - Treasury’s reporting of certain financial information required by GAAP continues to be impaired. Due to certain material weaknesses noted in our audit report—for example, commitments and contingencies related to treaties and other international agreements—Treasury is precluded from determining if additional disclosure is required by GAAP in the consolidated financial statements, and we are precluded from determining whether the omitted information is material. Further, Treasury’s ability to report information in accordance with GAAP will also remain impaired until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

A detailed discussion of additional control deficiencies regarding the process for preparing the consolidated financial statements can be found on pages 226 through 229 of the *Financial Report*.

During fiscal year 2009, Treasury, in coordination with OMB, continued implementing corrective action plans and made progress in addressing certain internal control deficiencies we have previously reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control deficiencies will be a difficult challenge and

¹⁶Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to net operating cost, it reported this amount as a component of net operating cost in the consolidated financial statements.

will require a strong commitment from Treasury and OMB as they continue to execute and implement their corrective action plans.

Addressing Other Impediments

While not as significant as the major impediments noted above, financial management problems at the Department of Homeland Security (DHS), the National Aeronautics and Space Administration (NASA), and the Department of State (State) also contributed to the disclaimer of opinion on the federal government's accrual-based consolidated financial statements for fiscal year 2009. About \$48 billion, or about 2 percent, of the federal government's reported total assets as of September 30, 2009, and approximately \$101 billion, or about 3 percent, of the federal government's reported net cost for fiscal year 2009 relate to these three agencies. According to auditors for DHS, NASA, and State, these agencies continue to have reported material weaknesses in internal control. While the auditors for DHS and NASA noted certain progress in financial reporting, each of the three agency auditors also reported that they were unable to provide opinions on the financial statements because they were not able to obtain sufficient evidential support for amounts presented in certain financial statements. For example,

- only selected DHS financial statements were subjected to audit, and the auditors stated that DHS was unable to provide sufficient evidence to support certain financial statements balances at the Coast Guard and Transportation Security Administration;
- auditors for NASA identified issues related to internal control in its property accounting, principally relating to assets capitalized in prior years; and
- auditors for State reported that the department was unable to provide sufficient support for the amounts presented in the fiscal year 2009 Combined Statement of Budgetary Resources and the property and equipment balance.

The auditors for DHS, NASA, and State made recommendations to address control deficiencies at the agencies, and management for these agencies generally expressed commitment to resolve the deficiencies. It will be important that management at each of these agencies remain committed to addressing noted control deficiencies and improving financial reporting.

Impacts of the Recession and Stabilization Efforts on the Federal Government's Financial Condition

The federal government reported a net operating cost of \$1.3 trillion and a unified budget deficit of \$1.4 trillion for fiscal year 2009, significantly higher than the amounts in fiscal year 2008. As of September 30, 2009, debt held by the public increased to 53 percent of gross domestic product (GDP). These increases are primarily the result of the effects of the recession and the costs of the federal government's actions to stabilize the financial markets and to help promote economic recovery.

In December 2007, the United States entered what has turned out to be its deepest recession since the end of World War II. Between the fourth quarter of 2007 and the third quarter of 2009, GDP fell by about 2.8 percent. The nation's unemployment rate rose from 4.9 percent in 2007 to 10.2 percent in October 2009, a level not seen since April 1983. Federal tax revenues automatically decline when GDP and incomes fall, and at the same time, spending on unemployment benefits and other income-support programs automatically increases.

As of September 30, 2009, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in an increase in reported federal assets of over \$500 billion (e.g., Troubled Asset Relief Program (TARP) equity investments, and investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and mortgage-backed securities guaranteed by them), which is net of about \$80 billion in valuation losses. In addition, the federal government reported incurring additional significant liabilities (e.g., liquidity guarantees to Fannie Mae and Freddie Mac) and related net cost resulting from these actions. Because the valuation of these 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.

In addition, the federal government's financial condition will be further affected as its actions continue to be implemented in fiscal year 2010 and later. For example, several hundred billion dollars of the total estimated \$862 billion cost under the American Recovery and Reinvestment Act of

2009 (Recovery Act)¹⁷ remain to be disbursed.¹⁸ Also, continued implementation of TARP,¹⁹ which was extended through October 3, 2010, is likely to result in additional cost, and the Federal Housing Administration (FHA) mortgage guarantee program could result in additional cost. Consequently, the ultimate cost of the federal government's actions and their effect on the federal government's financial condition will not be known for some time.

Further, there are risks that the federal government's financial condition could be affected in the future by other factors, including the following:

- Several initiatives undertaken in 2009 by the Federal Reserve to stabilize the financial markets have led to a significant change in the reported composition and size of the Federal Reserve's balance sheet, including the purchase of over \$900 billion in mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association as of the end of 2009. If the Federal Reserve sells these securities at a loss, additional federal government deposits at the Federal Reserve may be needed, future payments of Federal Reserve earnings to the federal government may be reduced, or both.²⁰
- Although the Recovery Act provided some fiscal relief to the states, expected continued state fiscal challenges could place pressure on the federal government to provide further relief to them.

Looking ahead, the federal government will need to determine the most expeditious manner in which to bring closure to its financial stabilization initiatives while optimizing its investment returns. In addition to managing these actions, problems in the nation's financial sector have exposed serious weaknesses in the current U.S. financial regulatory system, which, if not effectively addressed, may cause the system to fail to prevent similar or even worse crises in the future. The current system, which was put into place over the past 150 years, is fragmented and complex and simply has

¹⁷Pub. L. 111-5, 123 Stat. 115 (Feb. 17, 2009).

¹⁸Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (Washington, D.C.: January 2010).

¹⁹GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, [GAO-10-301](#) (Washington, D.C.: Dec. 9, 2009).

²⁰Under Federal Reserve System policy, Federal Reserve bank earnings in excess of statutory dividends to member banks are paid to the federal government. The federal government received about \$34 billion of such payments in fiscal year 2009.

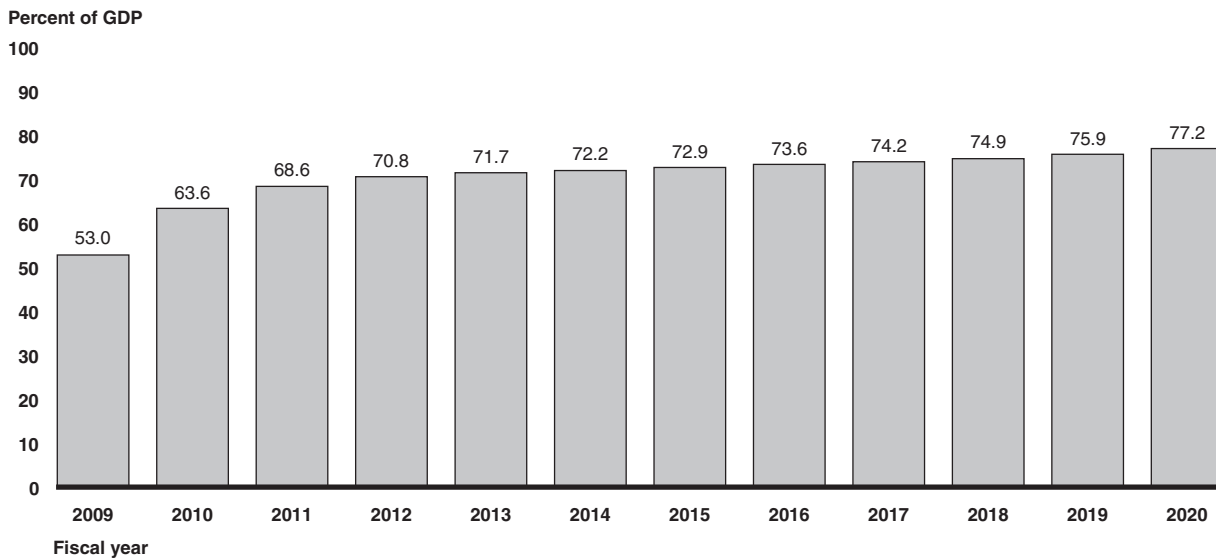
not kept pace with the major financial structures, innovations, and products that emerged during the years leading up to the recent financial crisis. Consequently, meaningful financial regulatory reform is of utmost concern. In crafting and evaluating proposals for financial regulatory reform, it will be important for Congress and others to be mindful of the need to use a framework that facilitates a comprehensive assessment of the relative strengths and weaknesses of each proposal. GAO has previously set forth such a framework that involves nine key elements that are critically important in establishing the most effective and efficient financial regulatory system possible: (1) clearly defined regulatory goals; (2) appropriately comprehensive; (3) systemwide focus; (4) flexible and adaptive; (5) efficient and effective; (6) consistent consumer and investor protection; (7) regulator provided with independence, prominence, authority, and accountability; (8) consistent financial oversight; and (9) minimal taxpayer exposure.²¹

The Near- and Long-Term Fiscal Challenges

The economic downturn and the nature and magnitude of the actions taken to stabilize the financial markets and to promote economic recovery will continue to shape the federal government's near-term budget and debt outlook. Actions taken to stabilize financial markets—including aid to the automotive industry—increased borrowing and added to the federal debt. The revenue decreases and spending increases enacted in the Recovery Act also added to borrowing and debt. As shown in figure 1, the President's budget projects debt held by the public growing from 53.0 percent of GDP in fiscal year 2009 to 63.6 percent by the end of fiscal year 2010 and 68.6 percent by the end of fiscal year 2011. While deficits are projected to decrease as federal support for states and the financial sector winds down and the economy recovers, the increased debt and related interest costs will remain.

²¹GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009).

Figure 1: Debt Held by the Public Under the President’s Fiscal Year 2011 Budget



Source: Office of Management and Budget.

Note: The data are from *Budget of the United States Government, Fiscal Year 2011: Summary Tables*.

Further, all of this takes place in the context of the current long-term fiscal outlook. The federal government faced large and growing structural deficits—and hence rising debt—before the instability in financial markets and the economic downturn. While the drivers of the long-term fiscal outlook have not changed, the sense of urgency has. As table 1 shows, many of the pressures highlighted in GAO’s simulations, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have previously served to reduce the unified budget deficit; however, the Congressional Budget Office (CBO) recently estimated that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees’ estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the federal budget. With the passage of time the window to address this challenge narrows.

Table 1: Pressures on the Federal Budget in the Near Term

2008	Oldest members of the baby-boom generation became eligible for early Social Security retirement benefits
2008	Medicare Hospital Insurance (HI) outlays exceeded cash income
2010	Social Security runs first cash deficit since 1984 ^a
2011	Oldest members of the baby-boom generation become eligible for Medicare
2014	45 percent of Medicare outlays funded by general revenue ^b
2016	Social Security begins running consistent annual cash deficits
2017	Medicare HI trust fund exhausted. Income sufficient to pay about 81 percent of benefits ^b
2020	Debt held by the public under GAO's Alternative simulation exceeds the historical high reached in the aftermath of World War II

Source: GAO analysis.

^aBased on CBO's January 2010 baseline projections.

^bBased on *2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (May 12, 2009). Projections showing the percentage of funding from general revenue reaching 45 percent by law trigger a "Medicare funding warning," requiring a proposal from the President in response.

The federal government is on an unsustainable long-term fiscal path driven on the spending side primarily by rising health care costs and known demographic trends. The Statement of Social Insurance, for example, shows that the present value of projected scheduled benefits exceed earmarked revenues for social insurance programs (e.g., Social Security and Medicare) by approximately \$46 trillion²² over the 75-year period. Since GAO's long-term fiscal simulations include projections of revenue and expenditures for all federal programs, they present a comprehensive analysis of the sustainability of the federal government's long-term fiscal outlook. Figures 2, 3, and 4 show the results of our most recent long-term fiscal simulations that were issued in March 2010.²³

Absent a change in policy, federal debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World

²²On an open group basis (current and future participants).

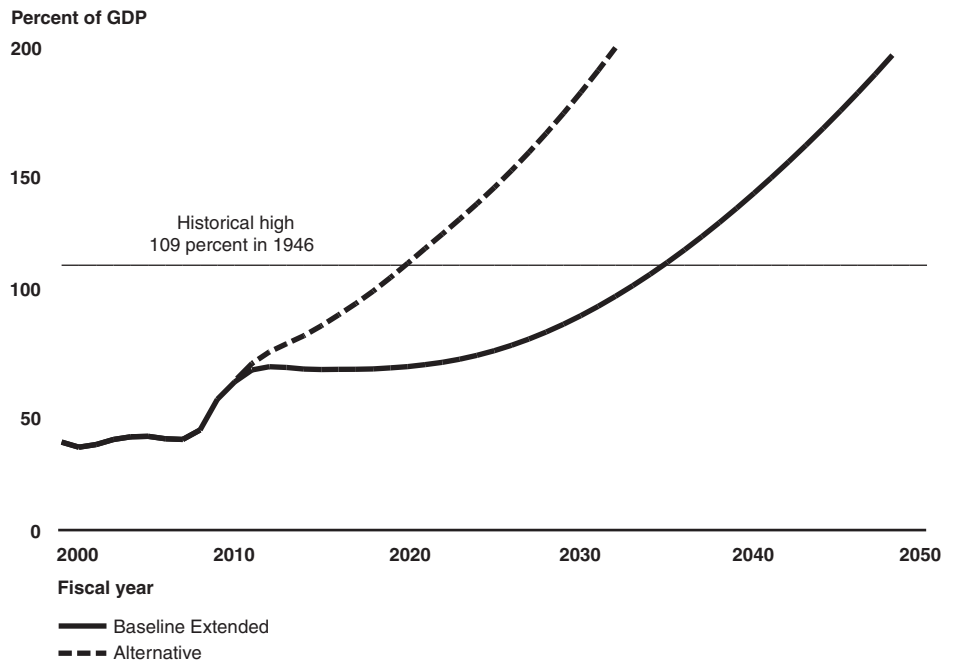
²³GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, [GAO-10-468SP](#) (Washington, D.C.: March 2010).

War II by 2020 (see fig. 2)²⁴ —10 years sooner than our simulation showed just 2 years ago. As a result, the administration and Congress will need to apply the same level of intensity to the nation’s long-term fiscal challenge as they have to the recent economic and financial market issues. Although the economy is still fragile, there is wide agreement on the need to begin to change the long-term fiscal path as soon as possible without slowing the recovery because the magnitude of the changes required grows with time. Congress recently enacted a return to statutory PAYGO—a budgetary control requiring that the aggregate impact of increases in mandatory spending or reductions in revenue generally be offset.²⁵ Although this can prevent further deterioration of the fiscal position, it does not deal with the existing imbalance. In February, the President established a commission to identify policies to change the fiscal path and stabilize the debt-to-GDP ratio.

²⁴This is under GAO’s January 2010 Alternative simulation, which assumes discretionary spending other than the Recovery Act provisions grows with GDP after 2010; the Recovery Act provisions are included but assumed to be temporary. Expiring tax provisions are extended and the 2009 Alternative Minimum Tax exemption amount is indexed to inflation through 2020. After 2020, revenue as a share of GDP is brought to its 40-year historical average of 18.1 percent of GDP. Medicare spending is adjusted based on the assumption that physician fees are not reduced as specified under current law.

²⁵For details on the rules governing the implementation of PAYGO, see Public Law 111-139.

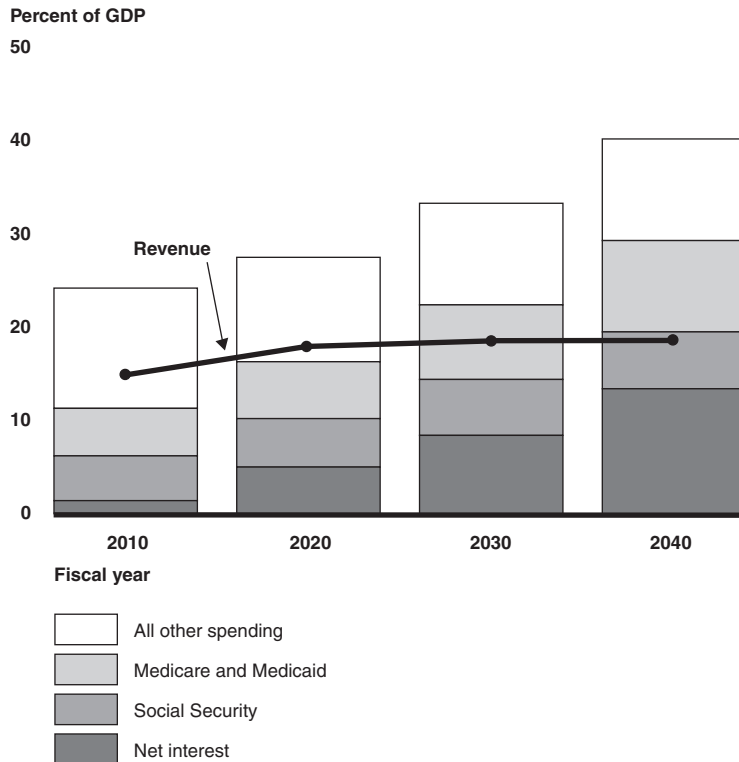
Figure 2: Debt Held by the Public Under Two Fiscal Policy Simulations



Source: GAO.

Note: Information presented for fiscal years 2000 through 2009 is based on historical data and for fiscal years 2010 through 2050 is derived from fiscal policy simulations. See [GAO-10-468SP](#).

Figure 3: Revenues and Composition of Spending as Shares of GDP Under GAO’s Alternative Simulation



Source: GAO.

Note: Data from GAO’s January 2010 analysis based on the Trustees’ assumptions for Social Security and Medicare. See [GAO-10-468SP](#).

One quantitative measure of the long-term fiscal challenge is called the “fiscal gap.” The fiscal gap is the amount of spending reductions or tax increases, over a certain time period such as 75 years, that would be needed to keep debt as a share of GDP at or below today’s ratio. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 2. The fiscal gap can be expressed as a share of the economy or in present value dollars.

Under GAO’s Alternative simulation, closing the fiscal gap would require spending cuts or tax increases, or some combination of the two averaging 9.0 percent of the entire economy over the next 75 years, or about \$76.4 trillion in present value terms. To put this in perspective, closing the gap solely through revenue increases would require annual increases in federal tax revenues of about 50 percent on average, or to do it solely through

spending reductions would require annual reductions in federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) of about 34 percent on average over the entire 75-year period.

Policymakers could phase in policy changes so that tax increases or spending cuts or both would grow over time allowing time for the economy to recover and for people to adjust to the changes. However, the longer action to deal with the long-term outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

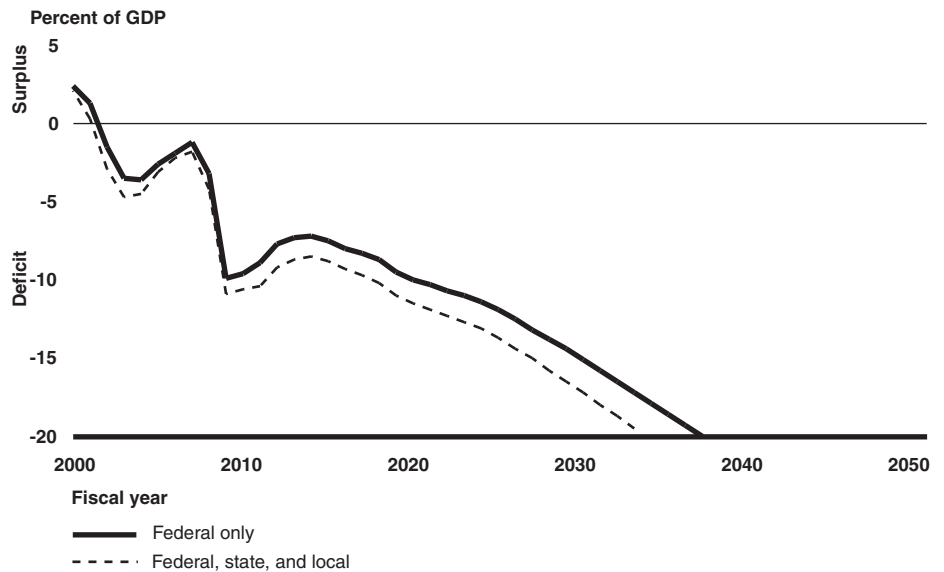
Comprehensive long-term fiscal projections will be required in the federal government's financial statements beginning in fiscal year 2010, under a new accounting standard.²⁶ Such reporting will include information about the long-term fiscal condition of the federal government and annual changes therein, and will expand upon the information currently provided in the Management's Discussion and Analysis section of the *Financial Report*.

It is not only the federal government that faces a long-term fiscal challenge. Figure 4 shows the federal and combined federal, state, and local surpluses and deficits as a share of GDP from our most recent simulation results.²⁷

²⁶Statement of Federal Financial Accounting Standards (SFFAS) No. 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government* (Washington, D.C.: Sept. 28, 2009).

²⁷See GAO, *State and Local Governments' Fiscal Outlook: March 2010 Update*, [GAO-10-358](#) (Washington, D.C.: Mar. 2, 2010).

Figure 4: Federal and Combined Federal, State, and Local Surpluses and Deficits



Source: GAO.

Note: Information presented for fiscal years 2000 through 2009 is based on historical data and for fiscal years 2010 through 2040 is derived from fiscal policy simulations. The federal data are from GAO's Alternative simulation.

Closing Comments

In closing, even though progress has been made in improving federal financial management activities and practices, much work remains given the federal government's near-and long-term fiscal challenges and the need for Congress, the administration, and federal managers to have reliable, useful, and timely financial and performance information to effectively meet these challenges.

The need for such information and transparency in financial reporting is clearly evident. The recession and the federal government's unprecedented actions intended to stabilize the financial markets and to promote economic recovery have significantly affected the federal government's financial condition, especially with regard to certain of its investments and increases in its liabilities and net operating cost. Importantly, while such increases are reported in the U.S. government's consolidated financial statements for fiscal year 2009, the valuation of certain 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. Going forward, a

great amount of attention will need to be devoted to ensuring (1) that sufficient internal controls and transparency are established and maintained for all financial stabilization and economic recovery initiatives; and (2) that all related financial transactions are reported on time, accurately, and completely.

Further, sound decisions on the current and future direction of all vital federal government programs and policies are more difficult without reliable, useful, and timely financial and performance information. In this regard, for DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses and its efforts to achieve auditability. Consistent and diligent top management oversight toward achieving financial management capabilities, including audit readiness, will be needed. Moreover, the civilian CFO Act agencies must continue to strive toward routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis. Federal entities need to improve the government's financial management systems to achieve this goal.

Moreover, of utmost concern are the federal government's long-term fiscal challenges that result from large and growing structural deficits that are driven on the spending side primarily by rising health care costs and known demographic trends. This unsustainable path must be addressed soon by policymakers.

Finally, I want to emphasize the value of sustained congressional interest in these issues, as demonstrated by this Subcommittee's leadership. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold the top leadership of federal entities accountable for resolving the remaining problems and that they support improvement efforts.

Madam Chairwoman and Ranking Member Bilbray, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the Subcommittee may have at this time.

GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact Jeanette M. Franzel, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600, as well as Susan J. Irving, Director, Federal Budget Analysis, Strategic Issues, at (202) 512-6806. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Fiscal year 2009 Audit Results

Table 2: Chief Financial Officers (CFO) Act Agencies: Fiscal Year 2009 Audit Results and Principal Auditors

CFO Act agencies	Opinion rendered by agency auditor	Agencies' auditors reported material weaknesses or noncompliance^a	Principal auditor
Agency for International Development	Unqualified	√	Office of Inspector General (OIG)
Agriculture	Unqualified	√	OIG
Commerce	Unqualified	√	KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young, LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified		KPMG LLP
Health and Human Services	Unqualified	√	Ernst & Young, LLP
Homeland Security	^b	√	KPMG LLP
Housing and Urban Development	Unqualified	√	OIG
Interior	Unqualified	√	KPMG LLP
Justice	Unqualified		KPMG LLP
Labor	Unqualified		KPMG LLP
National Aeronautics and Space Administration	Disclaimer	√	Ernst & Young, LLP
National Science Foundation	Unqualified		Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified		Urbach Kahn & Werlin LLP
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		OIG
State	^c	√	Kearney & Company
Transportation	Unqualified	√	Clifton Gunderson LLP
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP

Source: GAO.

^aReported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

^bFor fiscal year 2009, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit; the auditor was unable to express an opinion on these two financial statements.

^cThe auditors disclaimed an opinion on the Department of State's fiscal year 2009 Statement of Budgetary Resources and rendered a qualified opinion on State's Consolidated Balance Sheet and the related Statements of Net Cost and Changes in Net Position.

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