U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
Washington, DC 20548

Comptroller General
of the United States

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The President

The President of the Senate

The Speaker of the House of Representatives

Financial Audit: Fiscal Years 2016 and 2015 Consolidated Financial Statements of the U.S. Government

This report transmits the results of GAO's audit of the U.S. government's fiscal years 2016 and 2015 consolidated financial statements. GAO's audit report is incorporated in the enclosed *Fiscal Year 2016 Financial Report of the United States Government* prepared by the U.S. Department of the Treasury (Treasury) in consultation with the Office of Management and Budget (OMB) in the Executive Office of the President.

To operate as effectively and efficiently as possible, 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. Our report on the U.S. government's consolidated financial statements for fiscal years 2016 and 2015 underscores that much work remains to improve federal financial management and that the federal government continues to face an unsustainable long-term fiscal path.

Our audit 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 accrual-based consolidated financial statements as of and for the fiscal years ended September 30, 2016, and 2015.[2] About 34 percent of the federal government's reported total assets as of September 30, 2016, and approximately 18 percent of the federal government's reported net cost for fiscal year 2016 relate to significant federal entities that, as of the date of our audit report, were unable to issue audited financial statements, were

[1]A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting 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 as of and for the fiscal years ended September 30, 2016, and 2015, 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.

unable to receive audit opinions on the complete set of financial statements, or received a disclaimer of opinion on their fiscal year 2016 financial statements.[3]

- Significant uncertainties (discussed in Note 22 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth, prevented us from expressing an opinion on the sustainability financial statements, which consist of the 2016 and 2015 Statements of Long-Term Fiscal Projections;[4] the 2016, 2015, 2014, 2013, and 2012 Statements of Social Insurance; and the 2016 and 2015 Statements of Changes in Social Insurance Amounts.[5] About $32.5 trillion, or 70.0 percent, of the reported total present value of future expenditures in excess of future revenue presented in the 2016 Statement of Social Insurance relates to Medicare programs reported in the Department of Health and Human Services' (HHS) 2016 Statement of Social Insurance, which received a disclaimer of opinion. A material weakness in internal control also prevented us from expressing an opinion on the 2016 and 2015 Statements of Long-Term Fiscal Projections.
- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2016.
- Material weaknesses and other scope limitations discussed in our audit report limited our tests of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year 2016.

Overall, significant progress has been made in improving federal financial management since the enactment of key federal financial management reforms in the 1990s. Importantly, almost all of the 24 Chief Financial Officers Act of 1990 (CFO Act) agencies received unmodified ("clean") opinions on their respective entities' fiscal year 2016 financial statements, up from 6 CFO Act agencies that received clean audit opinions in 1996. In addition, 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, the preparation and audit of individual federal entities' financial statements have identified numerous deficiencies, leading to corrective actions to strengthen federal entities' internal controls, processes, and systems.

However, since the federal government began preparing consolidated financial statements 20 years ago, three major impediments have 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 the Department of Defense (DOD) that have prevented its financial statements from being auditable, (2) the federal government's inability to

[3]As of the date of this audit report, the audited financial statements for the Department of Defense, Department of Housing and Urban Development, National Science Foundation, and Smithsonian Institution were not issued. The Department of Agriculture obtained an unmodified opinion on its consolidated balance sheet as of September 30, 2016, but its consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and the related notes for the fiscal year ended September 30, 2016, were not audited. The Railroad Retirement Board received a disclaimer of opinion on its 2016 financial statements.

[4]The Statements of Long-Term Fiscal Projections presents for all the activities of the federal government the present value of projected receipts and noninterest spending under current policy without change, the relationship of these amounts to projected gross domestic product, and changes in the present value of projected receipts and noninterest spending from the prior year.

[5]Statements of Social Insurance are presented for the current year and each of the 4 preceding years in accordance with U.S. generally accepted accounting principles. Also, the sustainability financial statements do not interrelate with the accrual-based consolidated financial statements.

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.

Although DOD was not able to issue its audited financial statements by the end of our 2016 audit completion date, it has consistently been unable to receive an audit opinion on its financial statements in the past. Treasury and OMB have represented to us that the previously reported DOD material weaknesses continue to exist. 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 has expanded to focus on four priorities—budgetary information, proprietary accounting data and information, asset accountability, and valuation—with an overall goal of having its department-wide financial statements audit ready by September 30, 2017.[6] Because budgetary information is widely and regularly used for management, one of DOD's highest interim priorities is to improve its budgetary information and processes underlying its Statement of Budgetary Resources (SBR).

Based on difficulties encountered in preparing for an audit of the SBR, DOD made a significant change to its FIAR Guidance that limited the scope of the first-year SBR audits for all DOD components.[7] As outlined in the November 2014 FIAR Plan Status Report and the November 2013 revised FIAR Guidance, the scope of initial SBR audits beginning in fiscal year 2015 is to focus on current-year budget activity, to be reported on a Schedule of Budgetary Activity (SBA).[8] This is intended to be an interim step toward achieving the audit of multiple-year budget activity required for an audit of the SBR. In making this strategic change, DOD officials concluded—based on the difficulties encountered in obtaining documentation for prior-year transactions on the U.S. Marine Corps SBR audit—that the most effective path to an audit of the SBR would be to start with reporting and auditing only current-year activity for fiscal year 2015 appropriations and expanding subsequent audits to include current-year appropriations and prior appropriations going back to fiscal year 2015. Consequently, certain DOD components—including the Departments of the Army, Navy, and Air Force—underwent their first SBA audits

[6]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 describe specific actions to be taken and the costs associated with ensuring that DOD's financial statements are validated as ready for audit by September 30, 2017. In addition, section 1005 of the National Defense Authorization Act for Fiscal Year 2013, Pub. L. No. 112-239, 126 Stat. 1632, 1904-05 (Jan. 2, 2013), enacted a requirement for DOD's FIAR Plan to describe specific actions to be taken and the costs associated with ensuring that one of DOD's financial statements, the Statement of Budgetary Resources, would be validated as ready for audit by September 30, 2014, but DOD has acknowledged that it did not meet this target date. More recently, section 1003 of the National Defense Authorization Act for Fiscal Year 2014, Pub. L. No. 113-66, 127 Stat. 672, 842 (Dec. 26, 2013) (*reprinted in* 10 U.S.C. § 2222 note), mandated an audit of DOD's fiscal year 2018 financial statements and that the audit results be submitted to Congress by March 31, 2019.

[7]The FIAR Guidance was first issued by the DOD Comptroller in May 2010 and provides a standardized methodology for DOD components to follow for achieving financial management improvements and auditability. The DOD Comptroller periodically updates this guidance.

[8]Unlike the SBR, which reflects multiple-year budget activity, the SBA reflects the balances and associated activity related only to funding from fiscal year 2015 forward. As a result, the SBAs exclude unobligated and unexpended amounts carried over from funding prior to fiscal year 2015 as well as information on the status and use of such funding (e.g., obligations incurred and outlays) in fiscal year 2015 and thereafter.

for fiscal year 2015. Those DOD components' SBAs were again audited for fiscal year 2016, but with an expanded scope that included beginning balances carried over from fiscal year 2015. Independent public accountants (IPA) issued disclaimers of opinion for all three DOD components' SBAs for both of these fiscal years and identified material weaknesses in internal control at all three DOD components. These material weaknesses included the inability to reasonably assure that the SBAs reflected all of the relevant financial transactions that occurred and that documentation was available to support such transactions. During the fiscal year 2016 and 2015 audits, the IPAs collectively issued hundreds of findings and recommendations. The three DOD components' management officials have generally concurred with the findings in the respective IPA reports and are at various stages of developing and implementing corrective actions to address the IPAs' recommendations.

In its November 2016 FIAR Plan Status Report, DOD reported that for fiscal year 2017, the Army and Navy will expand the scope of their audits to full SBRs, and the Air Force will again undergo an SBA audit. In addition, the U.S. Marine Corps will undergo its first audit of all its financial statements for fiscal year 2017. However, DOD still needs to address the seven critical capabilities that it has identified as necessary to achieve audit readiness.[9] Moreover, in its November 2016 FIAR Plan Status Report, DOD stated that it expects to receive disclaimers of opinion on its financial statements for a number of years.

Various efforts are also under way to address the other two major impediments to an audit of the consolidated financial statements. For example, during fiscal year 2016, Treasury continued to actively work with significant federal entities[10] to resolve differences in intragovernmental activity and balances between federal entities through its quarterly scorecard process.[11] This process highlights differences requiring the entities' attention, identifies differences that need to be resolved through a formal dispute resolution process,[12] and reinforces the entities' responsibilities to resolve intragovernmental differences. Treasury also continues to develop and refine policies and procedures over accounting for and reporting all significant activity and balances of the General Fund of the U.S. Government (General Fund),[13] and continues to

[9]According to the April 2016 FIAR Guidance, these critical capabilities are related to DOD's inability to (1) provide a complete universe of transactions that is reconciled to feeder systems; (2) reconcile Fund Balance with Treasury (i.e., balance its checkbook); (3) provide supporting documentation for material adjustments to its financial records; (4) establish an auditable baseline/process for the existence, completeness, and rights of assets; (5) establish an auditable valuation baseline/process for the valuation of assets; (6) establish an auditable process for estimating and recording environmental and disposal liabilities; and (7) implement critical information technology general and application controls for material, financially relevant systems.

[10]OMB and Treasury have identified 39 federal entities that are significant to the U.S. government's fiscal year 2016 consolidated financial statements, including the 24 CFO Act agencies. See *Treasury Financial Manual*, vol. I, pt. 2, ch. 4700, for a listing of the 39 entities.

[11]For each quarter, Treasury produces a scorecard for each significant entity that reports various aspects of the entity's intragovernmental differences with its trading partners, including the composition of the differences by trading partner and category. Entities are expected to resolve, with their respective trading partners, the differences identified in their scorecards.

[12]When an entity and its respective trading partner cannot resolve an intragovernmental difference, the entity must request that Treasury resolve the dispute. Treasury will review the dispute and issue a decision on how to resolve the difference, which the entities must follow.

[13]The General Fund is a component of Treasury's central accounting function. It is a stand-alone reporting entity that comprises the activities fundamental to funding the federal government (e.g., issued budget authority, cash activity, and debt financing activities).

improve its reconciliation process of the activity and balances between the General Fund and federal entity trading partners. Treasury is also in the process of performing an internal assessment of the audit readiness of the General Fund. Further, over the past few years, Treasury has implemented new systems to collect certain additional data from entities and to compile the consolidated financial statements and new or enhanced procedures to address certain internal control deficiencies detailed in our previously issued report.[14] To help address the magnitude of the issues in these areas, it will be important that Treasury continues to develop and implement its policies and procedures for General Fund-related activity and balances, including the use of the General Fund as a trading partner, and obtain an audit of the General Fund activity and balances. In addition to continued leadership by Treasury and OMB, strong and sustained commitment by federal entities is critical to fully address these issues.

The material weaknesses underlying these three major impediments have 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. Over the years, we have made a number of recommendations to OMB, Treasury, and DOD to address these issues.[15] These entities have taken or plan to take actions to address these recommendations.

In addition to the material weaknesses referred to above, we identified three 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 them,[16] (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, and (3) effectively manage its tax collection activities. Our audit report presents additional details concerning these material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations. Until the problems outlined in our audit report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

Additionally, there are risks that certain factors could affect the federal government's financial condition in the future, including the following:

- The Pension Benefit Guaranty Corporation's (PBGC) financial future is uncertain because of long-term challenges related to PBGC's governance and funding structure. PBGC's liabilities exceeded its assets by over $79 billion as of the end of fiscal year 2016—an increase of over $3 billion from the end of fiscal year 2015 and of about $44 billion since

[14]GAO, *Management Report: Improvements Needed in Controls over the Processes Used to Prepare the U.S. Consolidated Financial Statements*, GAO-16-621 (Washington, D.C.: July 13, 2016).

[15]See GAO-16-621. In addition, see GAO, *DOD Financial Management – High Risk Issue*, accessed on January 12, 2017, http://www.gao.gov/key_issues/dod_financial_management/issue_summary#t=1. Further, other auditors have made recommendations to DOD to improve DOD's financial management.

[16]When excluding DOD's Defense Finance and Accounting Service Commercial Pay program, federal entity-reported estimates of improper payments totaled $144.3 billion in fiscal year 2016, an increase from the prior year estimate of $136.7 billion. This increase was mostly attributable to increased program outlays in HHS's Medicaid program.

2013. PBGC reported that it is subject to potential further losses of $243 billion if plan terminations occur that are considered reasonably possible.

- In 2008, during the financial crisis, the federal government placed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) under conservatorship and entered into preferred stock purchase agreements with these government-sponsored enterprises (GSE) to help ensure their financial stability. The agreements with the GSEs could affect the federal government's financial position. At the end of fiscal year 2016, the federal government continued to report about $109 billion of investments in the GSEs, which is net of about $86 billion in valuation losses. The GSEs paid Treasury cash dividends of $11.5 billion and $20.4 billion during fiscal years 2016 and 2015, respectively. Although Treasury does not believe that any further draws by the GSEs are probable, the reported maximum remaining contractual commitment to the GSEs, if needed, is $258.1 billion. Importantly, the ultimate role of the GSEs in the mortgage market could affect the financial condition of the Federal Housing Administration, which in the past expanded its lending role in distressed housing and mortgage markets.
- The U.S. Postal Service (USPS) continues to be in a serious financial crisis as it has reached its borrowing limit of $15 billion and finished fiscal year 2016 with a reported net loss of $5.6 billion. USPS's business model is not viable and cannot fund its current level of services, operations, and obligations.[17] USPS's liabilities exceeded its assets by $56 billion as of the end of fiscal year 2016 and USPS reported an additional $39.5 billion in unfunded liabilities at that time for its retiree health and pension funds. USPS reported a total unfunded liability for its retiree health and pension funds of $73.4 billion, $33.9 billion of which relates to required prefunding payments for postal retirees' health benefits that have not been made and is included in the liabilities reported on its balance sheet.

Full implementation of the Digital Accountability and Transparency Act of 2014 (DATA Act) would enable federal agencies to report information that complements the annual audited financial statements and to provide much more detailed information on federal spending on federal programs, activities, and outcomes. The DATA Act holds great promise for improving the transparency and accountability of federal spending data by providing consistent, reliable, and complete data on federal spending and for helping decision makers in addressing the federal government's fiscal challenges. OMB and Treasury have taken significant steps toward implementing the DATA Act's various requirements, including establishing a data governance structure, developing government-wide data standards and technical specifications for data reporting, issuing guidance on how agencies should report certain data and provide quality assurances for submitted data, and designing a pilot for developing recommendations to reduce recipient reporting burden. Agencies have reported that they continue to face challenges implementing the DATA Act, including systems integration issues, lack of resources, evolving and complex reporting requirements, and inadequate guidance. Agencies are taking actions to mitigate these challenges; nevertheless, as we reported in December 2016, the information reported by agencies and their inspectors general indicates that some agencies are at increased risk of not fully meeting the May 2017 reporting deadline because of these challenges.[18] In order to fully and effectively implement the DATA Act, the federal government will need to continue addressing complex policy and technical issues. OMB and Treasury have

[17]GAO, *U.S. Postal Service's Financial Viability – High Risk Issue*, accessed on January 12, 2017, http://www.gao.gov/key_issues/us_postal_service_financial_viability/issue_summary.

[18]GAO, *DATA Act: OMB and Treasury Have Issued Additional Guidance and Have Improved Pilot Design but Implementation Challenges Remain*, GAO-17-156 (Washington, D.C.: Dec. 8, 2016).

made progress implementing 5 of our recommendations related to DATA Act implementation, as of December 2016. However, additional effort is needed to address 11 previous GAO recommendations that remain open.[19]

Resolving the problems outlined in our audit report is of utmost importance given the federal government's reported fiscal path. The comprehensive long-term fiscal projections presented in the Statement of Long-Term Fiscal Projections, and related information in Note 23 and in the unaudited Required Supplementary Information section of the *Fiscal Year 2016 Financial Report of the United States Government* (*2016 Financial Report*) show that absent policy changes, the federal government continues to face an unsustainable long-term fiscal path. GAO also prepares long-term federal fiscal simulations, using different sets of assumptions, which continue to show debt held by the public rising as a share of gross domestic product (GDP). Under GAO's Alternative simulation, which is discussed in our audit report, 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 *2016 Financial Report*. Under the Alternative simulation, debt held by the public as a share of GDP will surpass its historical high (106 percent in 1946) by 2032. Reliable and complete financial information for federal entities will be needed for making policy changes that effectively address the unsustainable long-term fiscal path. GAO plans to issue a report outlining its perspectives on the fiscal health of the federal government.

Our audit 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 Treasury and OMB 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 guide to the *Financial Report* is intended to help those who seek to obtain a better understanding of the *Financial Report* and is available on GAO's website at http://www.gao.gov.[20] In addition, the website includes a guide to understanding the differences between accrual and generally cash-based budget measures and provides a useful perspective on the different purposes that cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.[21]

We are sending copies of this report to the Majority and Minority Leaders of the U.S. Senate and House of Representatives, interested congressional committees, the Secretary of the Treasury, the Director of the Office of Management and Budget, and other agency officials. This report is also available at no charge on the GAO website at http://www.gao.gov.

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[19]See GAO-17-156, app. II, for a list of our previous recommendations relating to the DATA Act and their implementation status.

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

[21]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).

Our audit report was prepared under the direction of Robert F. Dacey, Chief Accountant, and J. Lawrence Malenich, Director, Financial Management and Assurance. Questions about this report can be directed to Mr. Dacey at (202) 512-3406 or daceyr@gao.gov or Mr. Malenich at (202) 512-3406 or malenichj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Gene L. Dodaro
Comptroller General
of the United States
Enclosure
(100723)