MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The fiscal year (FY) *2009 Financial Report of the United States Government (Report)* provides the President, Congress, and the American people with a comprehensive view of the Federal Government's finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The Report also discusses important financial issues and significant conditions that may affect future operations. This year's Report gives particular emphasis to two key issues: the Government's ongoing efforts to jump-start the economy and create jobs, and the need to achieve fiscal sustainability over the medium and long term.

Pursuant to 31 U.S.C. § 331(e)(1), the Department of the Treasury must submit the Report, which is subject to audit by the Government Accountability Office (GAO), to the President and Congress no later than six months after the September 30 fiscal year end. To encourage timely and relevant reporting, the Office of Management and Budget (OMB) accelerated both agency and governmentwide reporting deadlines to 45 days and 75 days after year end, respectively. However, for FY 2009, some agencies that were significantly impacted by the substantial reporting requirements of both the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (ARRA) were granted reporting deadline extensions, which consequently affected the timing of this Report.

The Report is prepared from the audited financial statements of specifically designated Federal agencies, including the Cabinet departments and many smaller, independent agencies (see organizational chart on the next page). GAO issued, as it has for the past twelve years, a 'disclaimer' of opinion on the accrual-based consolidated financial statements for the fiscal years ended September 30, 2009 and 2008. This means that sufficient information was not available for the auditors to determine whether the reported financial results were reliable. In FY 2009, 28 of the 35 most significant agencies earned unqualified opinions on their financial statement audits.[1] In addition, the Government earned an unqualified audit opinion on a Report component - the Statement of Social Insurance (SOSI) - for the third year in a row, indicating the auditor's opinion that the SOSI fairly presents the financial condition of the programs covered in that statement.

The FY 2009 *Financial Report* consists of:

- Management's Discussion and Analysis (MD&A), which provides management's perspectives on and analysis of information presented in the Report, such as financial and performance trends;
- Principal financial statements and the related footnotes to the financial statements;
- Supplemental and Stewardship Information; and
- GAO's Audit Report.

In addition, the Government has produced a Citizen's Guide to provide the American taxpayer with a quick reference to the key issues in the Report and an overview of the Government's financial health.

Mission & Organization

The Government's fundamental mission is derived from the Constitution: ***"…to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity."*** The Congress authorizes and agencies implement programs as missions and initiatives evolve over time in pursuit of key public services and objectives, such as providing for national defense, promoting health care, fostering income security, boosting agricultural productivity, providing veteran benefits and services, facilitating commerce, supporting housing and the transportation systems, protecting the environment, contributing to the security of energy resources, and helping States provide education.

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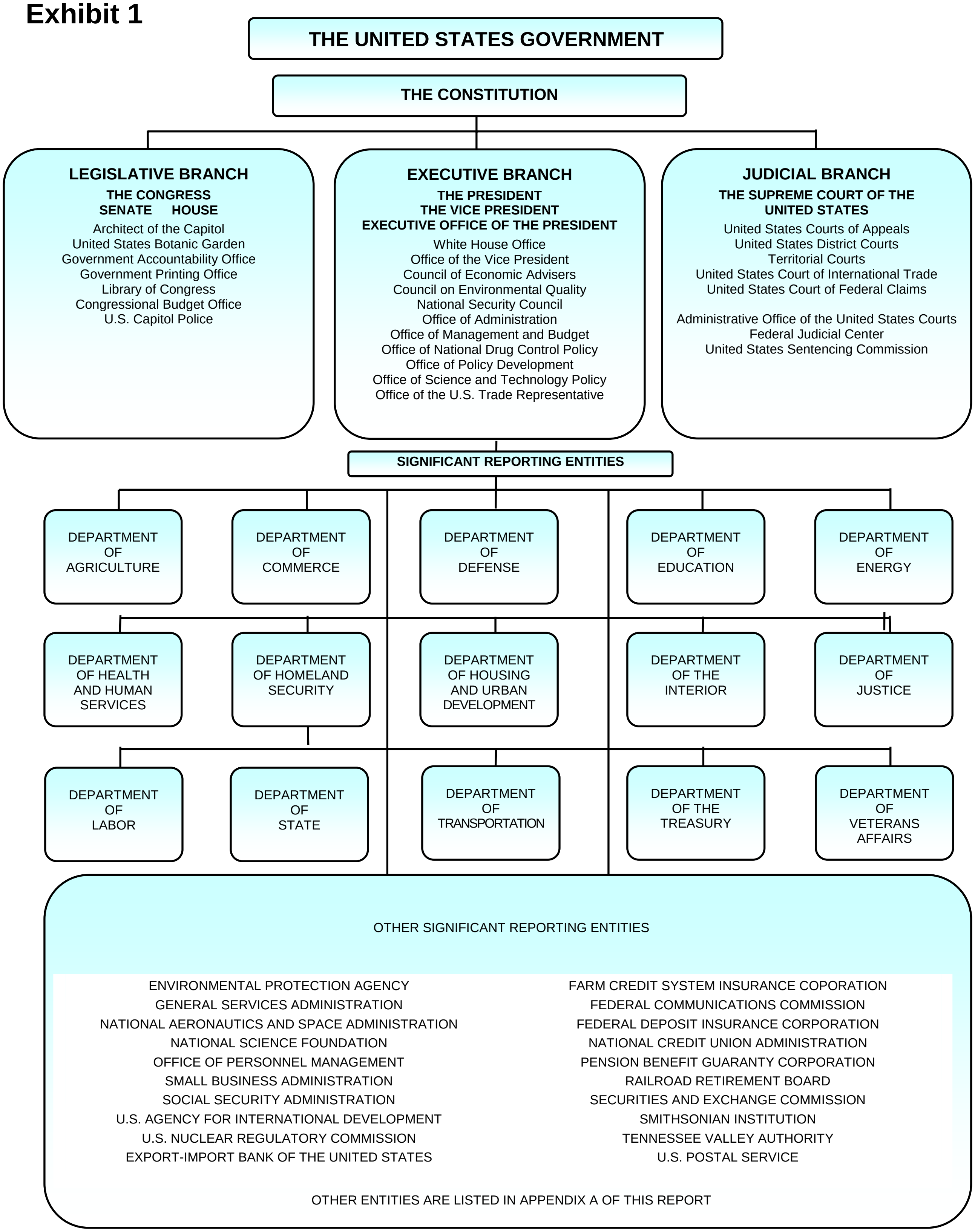
[1] Among the 35 significant entities are the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Farm Credit System Insurance Corporation (FCSIC), which operate on a calendar year basis (December 31 year end). These entities' 2009 audits are not yet complete.

Exhibit 1 provides an overview of how the U.S. Government is organized.

Exhibit 1



The Government's Financial Position and Condition

A complete assessment of the Government's financial or fiscal condition requires analysis of historical results, projections of future revenues and expenditures, and an assessment of the Government's long-term fiscal sustainability. As discussed later in this Report, the Government's financial statements show its financial position at the end of the fiscal year, explain how and why the financial position changed during the year, and provide insight into how the Government's financial condition may change in the future. In particular, the Statement of Social Insurance (SOSI) compares the actuarial present value of the Government's estimated expenditures for future scheduled benefits for Social Security, Medicare, and other social insurance programs over a 75-year period to a subset of the revenues that support these programs (e.g., the payroll taxes and revenue from taxation of benefits that support Social Security and Medicare Part A, but not the general revenues that support Medicare Parts B and D). Expected expenditures for other major programs (including defense, Medicaid, and education), future tax revenues, and the net cost of the Government's recent efforts to stabilize the economy will also affect the Government's future fiscal condition. The sustainability of social insurance and other major programs is discussed below in the section "The Long-Term Fiscal Outlook:'Where We Are Headed'.

Table 1
The Federal Government's Financial Position and Condition

Dollars in Billions		2009		2008
Gross Cost	$	(3,735.6)	$	(3,891.6)
Less: Earned Revenue	$	300.9	$	250.9
Net Cost of Operations	**$**	**(3,434.7)**	**$**	**(3,640.7)**
Less: Taxes and Other Revenue:	$	2,198.4	$	2,661.4
Net Operating Cost[1]	**$**	**(1,253.7)**	**$**	**(1,009.1)**
Assets[2]:				
Cash & Other Monetary Assets	$	393.2	$	424.5
Loans Receivable and Mortgage-Backed Securities, Net	$	538.9	$	253.8
TARP Direct Loans & Equity Investments, Net	$	239.7	$	-
Property, Plant & Equipment, Net	$	784.1	$	737.7
Other Assets	$	712.0	$	558.7
Total Assets	**$**	**2,667.9**	**$**	**1,974.7**
Liabilities[2] :				
Federal Debt Held by the Public	$	(7,582.7)	$	(5,836.2)
Federal Employee & Veterans Benefits	$	(5,283.7)	$	(5,318.9)
Other Liabilities	$	(1,257.4)	$	(1,023.1)
Total Liabilities	**$**	**(14,123.8)**	**$**	**(12,178.2)**
Net Position (Assets minus Liabilities)	**$**	**(11,455.9)**	**$**	**(10,203.5)**
Social Insurance Net Expenditures[3]:				
Social Security (OASDI)	$	(7,677)	$	(6,555)
Medicare (Parts A, B, & D)	$	(38,107)	$	(36,312)
Other	$	(94)	$	(104)
Total Social Insurance Net Expenditures	**$**	**(45,878)**	**$**	**(42,970)**
Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)[4]				
Social Security (OASDI)		-1.0%		-0.9%
Medicare (Parts A, B, & D)		-4.8%		-4.6%
Other		0.0%		0.0%
Total Net Expenditures as % of GDP		**-5.8%**		**-5.4%**

1 Source: Statement of Operations and Change in Net Position. Net Operating Cost includes adjustment for Unmatched Transactions and Balances

2 Source: Balance Sheet

3 Source: Statement of Social Insurance (SOSI). Amounts equal estimated present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain 'Social Insurance' programs (Social Security, Medicare Parts A, B, & D, Railroad Retirement, and Black Lung). Amounts reflect 'Open Group' totals (all current and projected program participants during the 75-year projection period).

4 Social Insurance values as reported in the Statement of Social Insurance. GDP values from the 2009 Social Security and Medicare Trust Fund Reports represent the present value of GDP over the 75 year projection period.

Note: totals may not equal sum of components due to rounding.

The natural starting point for assessing the Government's long-term financial condition is its current financial position, both in dollar terms and in relation to the economy as a whole. Gross Domestic Product (GDP) measures the size of the Nation's economy in terms of the total value of all final goods and services that are produced in a year. Considering financial results relative to GDP serves as a useful indicator of the economy's capacity to sustain the Government's many programs. For example:

- The Government's net operating cost, which includes accruals for anticipated future costs, increased from about $1.0 trillion in FY 2008 to approximately $1.3 trillion in FY 2009. By comparison, Government primarily cash-based outlays of $3.5 trillion, net of receipts of $2.1 trillion (approximately 25 percent and 15 percent of GDP, respectively) yielded a unified budget deficit for FY 2009 of about $1.4 trillion.
- The Government borrows from the public to finance the gap between cash-based outlays and receipts (the unified budget deficit) and to finance certain cash transactions that are not reflected in the deficit. The value, including interest, of publicly held debt was approximately $7.6 trillion (53 percent of GDP) at the end of FY 2009.
- Social insurance programs and Medicaid continue to represent a large share of Government cash-based expenditures. As reported in the Statement of Social Insurance (SOSI), over the next 75 years, the present value of expenditures for OASDI, Medicare (parts A, B, and D), Railroad Retirement, and Black Lung[2], are, absent policy changes, projected to exceed dedicated receipts for these programs by almost $46 trillion (nearly 6% of GDP over the 75-year period). Medicare Parts B and D are financed by general revenues. By accounting convention, the general revenues are eliminated in the consolidation of the financial statements at the governmentwide level and as such are not included in this calculation even though the expenditures on the components are included.

Fiscal Year 2009 Financial Statement Audit Results

Fiscal year 2009 was a difficult year for our nation's economy. In response, Congress passed several laws to help stimulate the economy and to help retain and create jobs, such as ARRA and EESA. Federal agencies were responsible for implementing new programs and expanding existing programs to carry out the goals of the stimulus package. In addition to managing the new or expanded programs, agencies were still held accountable to meet the OMB rigorous 45-day financial audit deadline. Twenty-two of the 24 CFO Act agencies met the 45-day deadline, with 19 agencies receiving clean audit opinions at that time.

This year, however, OMB granted one-month extensions to the Departments of State, Veterans Affairs, and the Treasury in accordance with OMB Memorandum M-10-04. The Memorandum allowed agencies to request a reporting extension due to the time and human resource constraints to implement economic recovery programs during the same time allotted to prepare and audit financial statements. The

Table 2: Summary of FY 2009 Financial Statement Audit Results by Agency

CFO Act Agencies	FY 2009 Audit Opinion
Department of Agriculture (USDA)	Unqualified
Department of Commerce (DOC)	Unqualified
Department of Defense (DOD)	Disclaimer
Department of Education (Education)	Unqualified
Department of Energy (DOE)	Unqualified
Department of Health and Human Services (HHS)	Unqualified
Department of Homeland Security (DHS)*	Disclaimer
Department of Housing and Urban Development (HUD)	Unqualified
Department of the Interior (DOI)	Unqualified
Department of Labor (DOL)	Unqualified
Department of Justice (DOJ)	Unqualified
Department of State (State)**	Disclaimer
Department of Transportation (DOT)	Unqualified
Department of the Treasury (Treasury)	Unqualified
Department of Veterans Affairs (VA)	Unqualified
Agency for International Development (USAID)	Unqualified
Environmental Protection Agency (EPA)	Unqualified
General Services Administration (GSA)	Unqualified
National Aeronautics and Space Administration (NASA)	Disclaimer
National Science Foundation (NSF)	Unqualified
Nuclear Regulatory Commission (NRC)	Unqualified
Office of Personnel Management (OPM)	Unqualified
Small Business Administration (SBA)	Unqualified
Social Security Administration (SSA)	Unqualified

* DHS' Balance Sheet and Statement of Custodial Activity were the only statements subject to audit.

** The Department of State's overall disclaimer is attributable to the disclaimer of its Statement of Budgetary Resources. State received qualified audit opinions on its Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position.

[2] The Black Lung program is projected through 2040.

Department of Veterans Affairs, however, was able to meet the reporting deadline and did not use the extension granted by OMB. Because of the extensions granted and used by the Departments of State and the Treasury, the FY 2009 *Financial Report* was issued on February 26, 2010 instead of the initially planned issuance date of December 15, 2009. This is still ahead of the statutory deadline of March 31, 2010. As shown in Table 2, of the 24 major Federal agencies, 20 received clean opinions.

The Governmentwide Reporting Entity

These financial statements conceptually cover the three branches of the Government (legislative, executive, and judicial). Legislative and judicial branch reporting focuses primarily on budgetary activity. Executive branch entities, as well as the Government Printing Office (a legislative branch agency) are required, by law, to prepare audited financial statements. Some other legislative branch entities voluntarily produce audited financial reports.

A number of entities and organizations are excluded due to the nature of their operations, including the Federal Reserve System (considered to be an independent central bank under the general oversight of Congress), all fiduciary funds, and government-sponsored enterprises, including the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. The Government increased its investment in the recovery effort in FY 2009 under the EESA, which gave the Secretary of the Treasury temporary authority to purchase and guarantee assets in a wide range of financial institutions and markets. Following GAAP for Federal entities, the Government has not consolidated into its financial statements the assets, liabilities, or results of operations of any financial organization or commercial entity in which Treasury holds either a direct, indirect, or beneficial majority equity investment. Even though some of the equity investments are significant, these entities meet the criteria under paragraph 50 of the Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, which directs that such investments should not be consolidated into the financial reports of the Federal Government, either in part or as a whole. A list of the significant agencies and entities contributing to this report is included in Appendix A.[3]

Limitations of the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Federal Government, pursuant to the requirements of 31 U.S.C. § 331(e)(1). These statements are in addition to the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

The following pages contain a more detailed discussion of the budget, the economy, and the debt, as well as a long-term view of the Government's ability to meet its obligations for social insurance and maintain its economic reinvestment and recovery efforts. The information in this Report, when combined with the President's Budget, collectively provides a valuable tool for managing current operations and planning future initiatives.

Systems, Controls, & Legal Compliance

Systems

As Federal agencies demonstrate success in obtaining and keeping an unqualified opinion on their audited financial statements, the Federal Government continues to face challenges in implementing financial systems that meet Federal requirements, but progress has been made. The number of agencies reporting compliance with the Federal Financial Management Improvement Act (FFMIA) continued to increase in FY 2009 from 15 to 17, and the number of auditors reporting compliance with FFMIA also increased from 10 to 14. The annual changes in compliances reported each year underscores the importance of current initiatives to standardize the financial management practices across the Federal Government.

This year, OMB updated Circular No. A-127, *Financial Management Systems*. The revised Circular is aimed at clarifying the definition of FFMIA substantial compliance so that auditors and agency heads interpret the

[3] Since programs are not administered at the governmentwide level, performance goals and measures for the federal Government, as a whole, are not reported here. The outcomes and results of those programs are addressed at the individual agency level and can be found in their individual reports.

guidance more consistently. The revised Circular also includes policies and standards for agencies to follow to improve management of financial systems.

Controls

Federal managers have a fundamental responsibility to develop and maintain effective internal control. Effective internal control helps to ensure that programs are managed with integrity and resources are used efficiently and effectively through three objectives: effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The safeguarding of assets is a subcomponent of each objective.

The OMB Circular No. A-123, *Management's Responsibility for Internal Control,* is the policy document that implements the requirements of 31 U.S.C. 3512 (commonly known as the Federal Managers' Financial Integrity Act or FMFIA). Circular No. A-123 primarily focuses on providing agencies with a framework for assessing and managing risks more strategically and effectively. The Circular contains multiple appendices that address, at a more detailed level, one or more of the objectives of effective internal control. Appendix A provides a methodology for agency management to assess, document, test, and report on internal controls over financial reporting. Appendix B requires agencies to maintain internal controls that reduce the risk of fraud, waste, and error in Government charge card programs. Appendix C implements the requirements of the Improper Payments Information Act, which includes the measurement, reporting, and remediation of improper payments.

In addition to the FY 2009 agency financial statement audit results, the total number of repeat material weaknesses remained at 29. However, the total number of material weaknesses increased from 32 to 38, primarily due to an increase of findings related to Financial Management and Reporting. Deficiencies in controls over the financial statement preparation process contributed to this increase; as such, improvements are needed in various areas, including oversight, data integrity, reconciliations, policies and procedures, and training. Effective internal controls are a challenge not only at the agency level, but also at the government-wide level. GAO reported that at the governmentwide level, material weaknesses resulted in ineffective internal control over financial reporting. While progress is being made at many agencies and across the Government in identifying and resolving internal control deficiencies, continued diligence and commitment are needed.

Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management. Compliance is addressed as part of agency financial statement audits. Agency auditors test for compliance with selected laws and regulations related to financial reporting. Certain individual agency audit reports contain instances of noncompliance. None of these instances were material to the Government-wide financial statements. However, GAO reported that its work on compliance with laws and regulations was limited by the material weaknesses and scope limitations discussed in its report.

The President's Budget and The Financial Report

Each year, the Administration issues two reports that detail financial results for the Federal Government: the *President's Budget*, which provides a plan for future initiatives and the resources needed to support them, as well as prior year fiscal and performance results; and this *Financial Report*, which provides the President, Congress, and the American people a broad, comprehensive overview of the cost on an accrual basis of the Government's operations, the sources used to finance them, its balance sheet, and the overall financial outlook.

Treasury generally prepares the financial statements in this Report on an 'accrual basis' of accounting as prescribed by U.S. generally accepted accounting principles (GAAP) for Federal entities.[4] These principles are tailored to the Government's unique characteristics and circumstances. For example, agencies prepare a uniquely structured 'Statement of Net Cost,' which is intended to present net Government resources used in its operations, instead of an 'Income Statement,' which private sector companies typically use to focus on profits or losses. Also

[4] Under GAAP, most U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable. The Statement of Social Insurance presents the present value of the estimated future revenues and expenditures for scheduled benefits over the next 75 years for the Social Security, Medicare, Railroad Retirement programs; and through 2040 for the Black Lung program.

unique to Government is the preparation of separate statements to reconcile differences and articulate the relationship between the budget and financial accounting results (e.g., Statement of Reconciliation of Net Operating Cost and Unified Budget Deficit and the Statement of Changes in Cash Balance from Unified Budget Deficit and Other Activities).

President's Budget	Financial Report of the U.S. Government
Prepared primarily on a '*cash basis*' • Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them. • Receipts ('cash in'), taxes and other collections recorded when received. • Outlays ('cash out'), recorded when payment is made.	Prepared on an '*accrual and modified cash basis*' • Agency-based and retrospective – prior and present resources used to implement initiatives. • Revenue: Tax revenue (more than 90 percent of total revenue) recognized on modified cash basis (see Financial Statement Note 1.B). Remainder recognized when earned, but not necessarily received. • Costs: recognized when owed, but not necessarily paid.

Budget Deficit vs. Net Operating Cost

Because of the severe economic downturn and the policy measures taken to stabilize the financial markets and help the economy recover, the budget deficit rose substantially in FY 2009. The Government incurred a unified budget deficit of about $1.4 trillion. Some government programs act as "automatic stabilizers," helping to support the economy during a downturn by increasing spending and reducing tax collections. This support is "automatic" because increased spending on programs like unemployment benefits, Social Security, and Medicaid, and a reduction in tax receipts happen even without any legislative changes in policies. The automatic stabilizers caused the deficit to surge during FY2009. In addition, the results of actions related to legislation enacted to bolster the economy added further to the deficit.

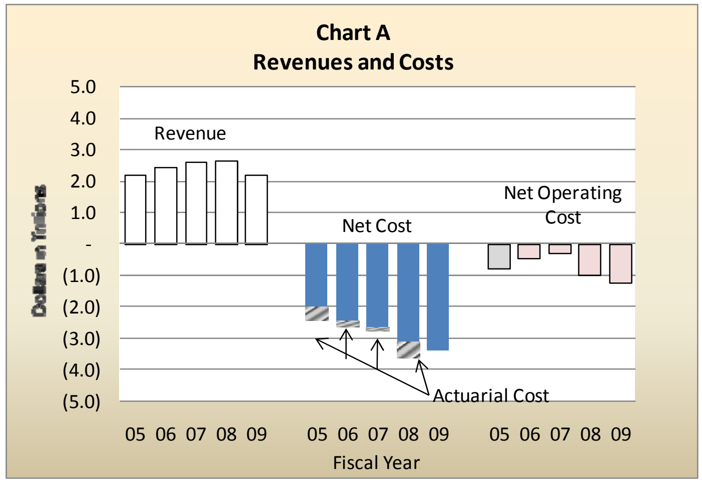
Table 3: Budget Deficit vs. Net Operating Cost

Dollars in Billions		2009		2008
Net Operating Cost	**$**	**(1,253.7)**	**$**	**(1,009.1)**
Change in:				
Liabilities for Veteran's Compensation	$	(149.2)	$	339.0
Liabilities for Military and Civilian Employee Benefits	$	114.0	$	210.8
TARP Downward Reestimate	$	(110.0)	$	-
Other	$	(18.2)	$	4.5
Budget Deficit	**$**	**(1,417.1)**	**$**	**(454.8)**

As noted earlier, the Government's net operating cost (which increased from an already record high of about $1.0 trillion in FY 2008 to approximately $1.3 trillion in FY 2009) typically exceeds the deficit due largely to the inclusion of cost accruals for estimated future postemployment benefit liabilities. However, for FY 2009, as will be discussed later in this report, the Department of Veterans Affairs substantially reduced its estimates of long-term veterans' benefit liabilities and costs. These estimate changes accounted for the largest single difference between deficit and net operating cost. In addition, there was a $110 billion downward re-estimate of the cost of the Troubled Asset Relief Program (TARP), which was recorded as a reduction in net operating cost for FY 2009, but will not be reflected in the budget deficit until FY 2010. Table 3 shows the factors that caused the budget deficit to uncharacteristically exceed net operating cost in FY 2009.

The Government's Net Position: "Where We Are"

The Government's financial position and condition have traditionally been expressed through the Budget, focusing on surpluses and deficits. However, this primarily cash-based discussion of the Government's net outlays (deficit) or net receipts (surplus) tells only part of the story. The Government's net position, which for FY 2009 was a negative $11.5 trillion, is driven simultaneously by the Government's revenues and expenses, as well as the changes in its assets and liabilities.



Revenues and Costs: "What Came In & What Went Out"

The Government's ***Statement of Operations and Change in Net Position***, much like a corporation's income statement, shows the Government's 'bottom line' and its impact on net position (i.e., assets net of liabilities). The Government nets its costs against both: (1) earned revenues from Government programs (e.g., Medicare premiums, National Park entry fees, and postal service fees) to derive net cost; and (2) taxes and other revenue to arrive at the Government's 'bottom line' net operating cost.

Chart A and Table 4 show that the Government has incurred a total net operating cost (i.e., costs have exceeded its revenues) over the past several years, causing net position to decline. The Government's revenues last exceeded its costs in FYs 1999 and 2000. Chart A also shows that despite declines in net costs, including a substantial decrease in actuarial cost estimates (discussed later), during FY 2009, a $463 billion decrease in taxes and other revenue resulted in an increase in net operating cost.

Table 4: Gross Cost, Revenues, and Net Cost

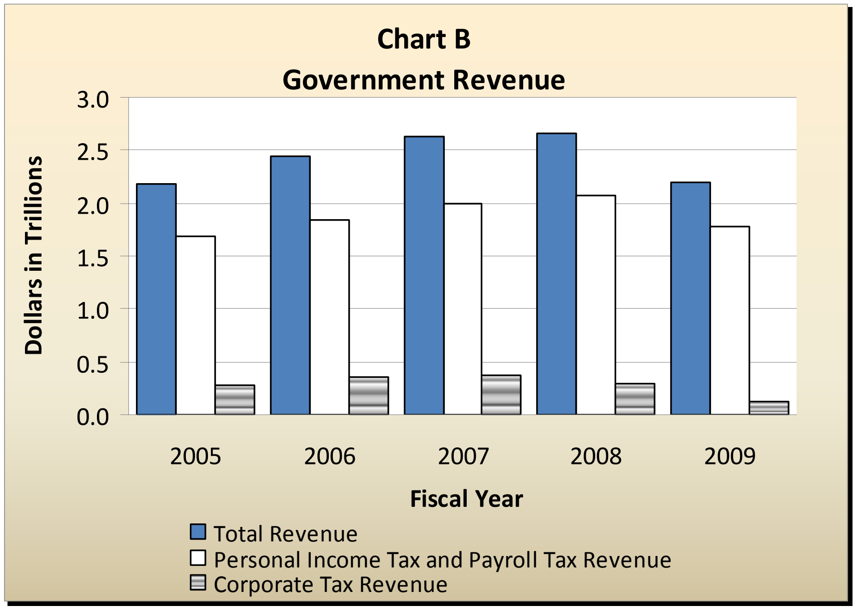
Dollars in Billions	2009	2008	Increase / (Decrease) $	Increase / (Decrease) %
Gross Cost				
HHS	$ (866.4)	$ (769.1)	$ 97.3	12.7%
SSA	$ (736.6)	$ (663.9)	$ 72.7	11.0%
DOD	$ (718.4)	$ (767.6)	$ (49.2)	-6.4%
Treasury	$ (254.6)	$ (197.0)	$ 57.6	29.2%
Interest on Treasury Securities Held by the Public	$ (189.1)	$ (241.6)	$ (52.5)	-21.7%
Other Federal Agencies	$ (970.5)	$ (1,252.4)	$ (281.9)	-22.5%
Total Gross Cost	**($3,735.6)**	**($3,891.6)**	**$ (156.0)**	**-4.0%**
Less: Earned Revenue	$300.9	$250.9	$ 50.0	20.0%
Net Cost	**($3,434.7)**	**($3,640.7)**	**$ (206.0)**	**-5.7%**
Less: Taxes & Other Revenue	$ 2,198.4	$ 2,661.4	$ (463.0)	-17.4%
Net Operating Cost[1]	**($1,253.7)**	**($1,009.1)**	**$ 244.6**	**24.2%**

[1] Net Operating Cost includes adjustment for Unmatched Transactions and Balances

The ***Reconciliation of Net Operating Cost and Unified Budget Deficit Statement*** shows how the Government's net operating cost from the primarily accrual-based financial statements relates to the more widely-known and primarily cash-based budget deficit. Most of this difference is attributable to accruals of actuarial costs associated with the estimated present value of the Federal Government's net postemployment liabilities. Chart A shows the effect of this 'actuarial' element on the Government's total net cost. These actuarial costs in recent years have also accounted for the majority of the annual change in the Government's total net cost. The Department of Veterans Affairs (VA) and other agencies use a number of assumptions, such as interest rates and life expectancy, to make annual actuarial projections of their long-term benefits liabilities and the related costs. As discussed below, changes in these assumptions can cause those projections, and consequently total costs, to fluctuate, sometimes significantly, from year to year.

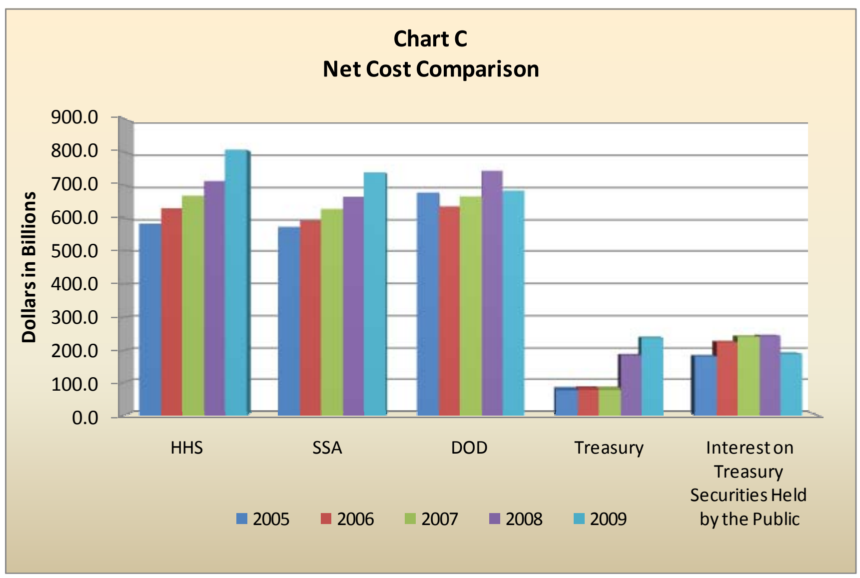
Revenue: "What Came In"

The ***Statement of Net Cost*** reports 'earned' revenue generated by Federal programs, including Medicare tax premiums paid by program participants and postal service fees. The ***Statement of Operations and Changes in Net Position*** shows the Government's taxes and other revenues (i.e., revenues other than 'earned'). As shown in Chart B, total Government revenues decreased $463 billion to about $2.2 trillion for FY 2009, due in great part to the effects of the recession. Individual income tax revenue (which decreased by nearly 15 percent), and corporate tax revenue (which decreased by more than 50 percent) account for the majority (nearly 90 percent) of total revenues.



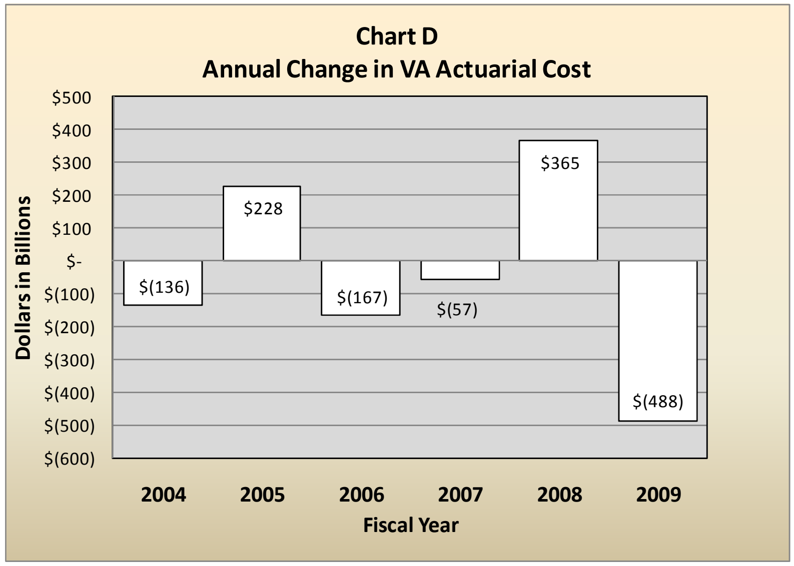
Cost: "What Went Out"

The ***Statement of Net Cost*** also shows how much it costs to operate the Federal Government, recognizing expenses when they happen, regardless of when payment is made (accrual basis). It shows the derivation of the Government's net cost of operations or the difference between costs of goods produced and services rendered by the Government during the fiscal year. This amount, in turn, is offset against the Government's taxes and other revenue in the ***Statement of Operations and Changes in Net Position*** to calculate the 'bottom line' or net operating cost.



In FY 2009, the Government's 'bottom line' net operating cost totaled about $1.3 trillion ($1,254 billion), an increase of nearly $250 billion over a then record FY 2008 net operating cost of approximately $1.0 trillion (see Table 4). Chart C shows the cost trends in the entities that contributed the most to the Government's net cost in FY 2009. The Department of Health and Human Services (HHS), the Department of Defense (DoD), and the Social Security Administration (SSA) have consistently incurred the largest agency shares of the Government's total net cost of operations in recent years, combining to comprise almost two-thirds of the Government's FY 2009 total net cost. The bulk of HHS and SSA costs are attributable to major social insurance programs administered by these agencies, e.g., Social Security and Medicare. The ***Statement of Social Insurance*** (SOSI) and the related information in this report discuss the projected future revenues, expenditures, and future sustainability of these programs in greater detail. DoD costs relate primarily to operational activities, environmental cleanup, and military retirement and health benefits. In addition to interest costs on Federal debt held by the public, the Department of the Treasury was another significant contributor to the Government's net cost in FY 2009. The majority of the increase in Treasury costs is attributable to the economic recovery effort, including TARP and Government-Sponsored Enterprise (GSE) investments.

As indicated earlier, the nearly $250 billion increase in net operating cost for FY 2009 was actually comprised of significant offsetting increases and decreases. In addition to the substantial decrease in revenues described earlier, net operating cost increased $94 billion at the Department of Health and Human Services (HHS) for medical benefits and $73 billion at the Social Security Administration (SSA) due to benefits payments made to the first wave of 'baby boomers' reaching retirement age and to the increase in disability and retirement benefit claims that occurs during a recession. However, these net cost increases were offset by a significant reduction in costs at the Department of Veterans Affairs (VA). VA's net cost decreased by $488 billion, resulting in a net revenue total of $43 billion for FY 2009.



This significant decrease in costs is attributable to VA's reestimation of its actuarial liability for and, consequently, anticipated cost of veterans' compensation benefits. According to VA, the 2009 decrease in the actuarial liability was primarily caused by a large decrease in the cost of living adjustment (COLA) assumption in the past year. The decrease was due in part to: (1) the decrease in inflation expectations that occurred during 2009 and (2) a change in methodology which aligned the assumption for future COLA rates with the assumption for future discount rates. Changes in these and other assumptions can cause wide fluctuations in an agency's cost and liability estimates and accruals (see Chart D for annual fluctuations in VA's actuarial costs). Table 5 shows the major components of this significant liability change, which, in addition to the COLA adjustment, include changes in discount rates and estimates of veteran eligibility. In the prior year, VA's net cost increased significantly because of an actuarial adjustment in the opposite direction. The liability decrease of $149 billion in FY 2009, when compared to a $339 billion increase in FY 2008, combine to cause a $488 billion decrease in actuarial cost estimates for FY 2009.

Table 5
Components of VA Federal Employee & Veteran Benefit Liability Change - FY 2009

Dollars in billions		$
Change in COLA assumption	$	(287)
Changes in original awards/new status	$	103
Changes in discount rates	$	62
Other sources	$	(27)
Total Change	**$**	**(149)**

The reason the VA's estimates fluctuate so much from year to year is that VA assumes that current period interest and inflation rates will persist into the future. Thus, when current rates change, projections of the future change as well. Starting with next year's financial statement, the VA plans to switch to a methodology more similar to that used in the Social Security and Medicare Trustees' Reports – in which projections of future economic variables reflect average historical rates rather than current period values.

Assets and Liabilities: "What We Own and What We Owe"

Table 6: Assets and Liabilities				
Net Position Dollars in Billions	**2009**	**2008**	Increase (Decrease) **$**	**%**
Assets				
Cash & Other Monetary Assets	$ 393.2	$ 424.5	$ (31.3)	-7.4%
Loans Receivable and Mortgage-Backed Securities, Net	$ 538.9	$ 253.8	$ 285.1	112.3%
TARP Direct Loans & Equity Investments, Net	$ 239.7	$ -	$ 239.7	n/a
Property, Plant & Equipment, Net	$ 784.1	$ 737.7	$ 46.4	6.3%
Other Assets	$ 712.0	$ 558.7	$ 153.3	27.4%
Total Assets	**$ 2,667.9**	**$ 1,974.7**	**$ 693.2**	**35.1%**
Less: Liabilities, comprised of:				
Federal Debt Held by the Public	$ (7,582.7)	$ (5,836.2)	$ 1,746.5	29.9%
Federal Employee & Veterans Benefits	$ (5,283.7)	$ (5,318.9)	$ (35.2)	-0.7%
Other Liabilities	$ (1,257.4)	$ (1,023.1)	$ 234.3	22.9%
Total Liabilities	**$ (14,123.8)**	**$ (12,178.2)**	**$ 1,945.6**	**16.0%**
Net Position (Assets Minus Liabilities)	**$ (11,455.9)**	**$ (10,203.5)**	**$ (1,252.4)**	**-12.3%**

Net Position at the end of the year can also be derived by netting the Government's assets against its liabilities, as presented in the ***Balance Sheet***. It is important to note that the balance sheet does not include the financial value of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. In addition, as was the case with the ***Statement of Operations and Changes in Net Position***, the ***Balance Sheet*** includes a separate presentation of the portion of net position earmarked for specific funds and programs. Moreover, the Government's exposures are broader than the liabilities presented on the balance sheet, if such items as the Government's future social insurance exposures (namely, Medicare and Social Security), as well as other commitments and contingencies, are taken into account. These exposures are discussed in this section as well as in the supplemental disclosures of this Report.

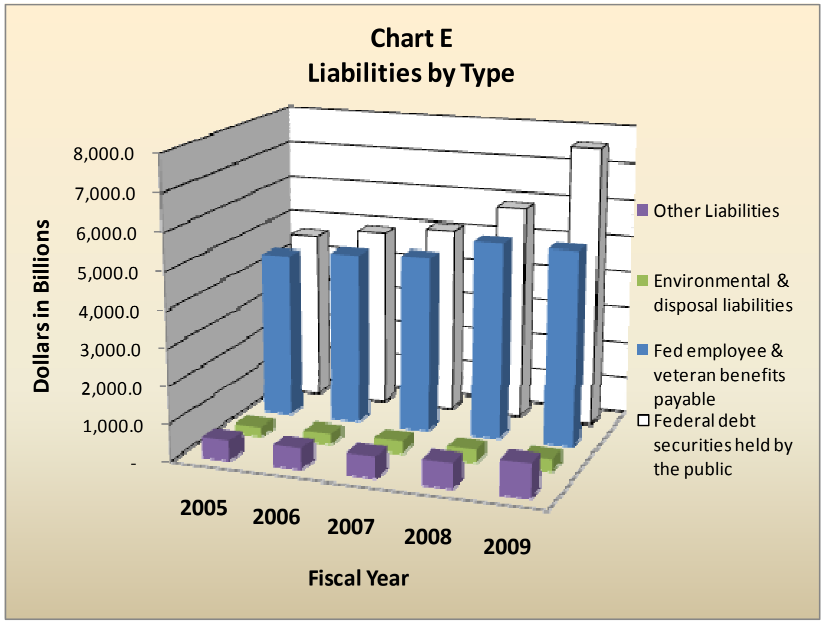
Assets – "What We Own"

As of September 30, 2009, the Government held about $2.7 trillion in assets, comprised mostly of net property, plant, and equipment ($784 billion in FY 2009) and a combined total of $778.6 billion in net loans receivable and investments, including nearly $240 billion associated with the TARP efforts. During FY 2009, the Government's total assets increased by $693.2 billion, due mostly to the $525 billion increase in TARP and other loans receivable and investments. As part of the market stabilization effort, the Government implemented the Supplementary Financing Program (SFP) - a temporary program announced on September 17, 2008, by Treasury and the Federal Reserve to help manage the impact on the Federal Reserve's balance sheet of its initiatives aimed at addressing the ongoing crisis in financial markets. At its height, this program accounted for $560 billion of the Government's cash balance. As of September 30, 2009, the total had been reduced to $165 billion, as outstanding SFP bills matured and were not reinvested in the program. On September 16, 2009, Treasury announced its intention to reduce the balance to $15 billion in the short run to preserve flexibility in the conduct of debt management policy. In addition to assets recorded on the balance sheet, the Government discloses that it also owns certain other stewardship assets such as land (e.g., national parks and forests) and heritage assets (e.g., national memorials and historic structures).

Liabilities – "What We Owe"

Chart E shows the major components of liabilities, or what the Government owes, as of September 30, for fiscal years 2005 through 2009. As indicated in Table 6, the largest liabilities in recent years have been Federal debt held by the public and accrued interest, the balance of which increased to $7.6 trillion in FY 2009. During the fiscal year, changes in economic conditions, as well as actions taken to address the downturn in the economy and instability in the financial markets, resulted in the need for an increase in borrowings from the public to finance federal spending.

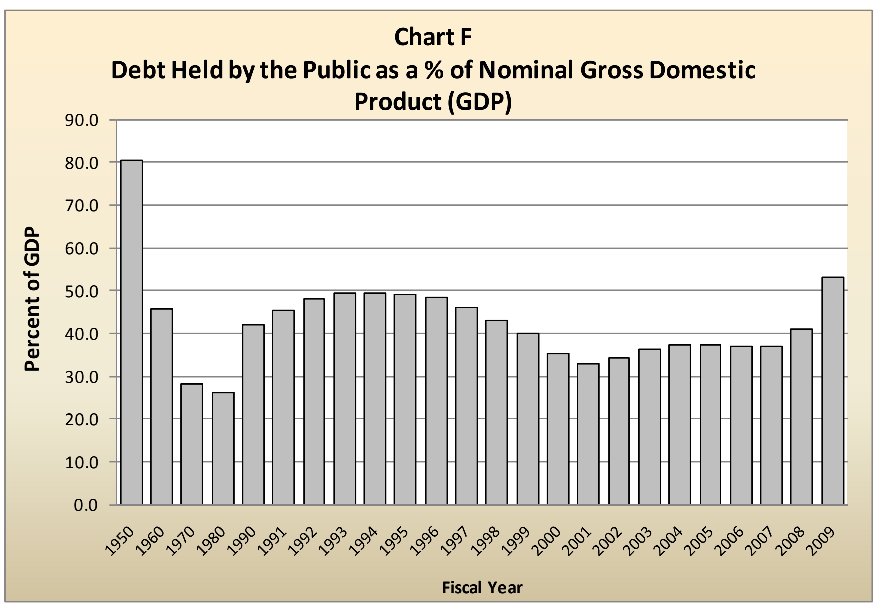
The other major component of the Government's liabilities is Federal employee postemployment and veteran benefits payable, which decreased during FY 2009, from $5,318.9 billion to $5,283.7 billion. As indicated earlier, this decrease was due largely to future benefit liability reestimates made by VA ($149 billion decrease), offset by benefit liability increases for current military and civilian government employees. Civilian benefits payable accounts for more than a third of the Federal Employee and Veterans Benefits liability. The Office of Personnel Management (OPM) administers the largest civilian pension plan, covering nearly 2.6 million current employees and over 2.5 million annuitants.[5] The military pension plan covers over 2.3 million current military personnel (including active service, reserve, and National Guard) and approximately 2.2 million retirees and annuitants.[6]



Environmental and disposal liabilities stayed relatively constant at about $342 billion as of September 30, 2009. The majority of these types of liabilities are attributable to the Departments of Defense and Energy for the clean-up of radioactive waste and other nuclear material stored at former testing and storage sites.

Federal Debt

As noted earlier, the unified budget surplus or deficit is the difference between total Federal spending and receipts (e.g., taxes) in a given year. The Government borrows from the public (increases Federal debt levels) to finance deficits. During a budget surplus (i.e., when receipts exceed spending), the Government typically uses those excess funds to reduce the debt held by the public. ***The Statements of Changes in Cash Balance from Unified Budget and Other Activities*** reports how the annual unified budget surplus or deficit relates to the Federal Government's borrowing and changes in cash and other monetary assets. It also explains how a budget surplus or deficit normally affects changes in debt balances.



The Government's borrowings from the public, including accrued interest, increased by $1.7 trillion in FY 2009. As indicated, typically, budget surpluses have resulted in borrowing reductions, and budget deficits have yielded borrowing increases. However, the Government's debt operations are much more complex than this would

[5] OPM FY 2009 Civil Service Disability Fund Report; OPM FY 2009 Performance and Accountability Report, p. 2.
[6] DoD FY 2009 Agency Financial Report, p. 5; DoD Military Retirement Fund (MRF) financial statements, p 9.

imply. Each year, trillions of dollars of debt matures and new debt takes its place. In FY 2009, new borrowings were $8.9 trillion and repayments of maturing debts held by the public were $7.2 trillion. Both represented substantial increases over new borrowings and debt repayments for FY 2008, respectively.

Historically, the Government has incurred debt when it borrows from the public to finance budget deficits. The economic recovery efforts of the past year have precipitated a need to borrow additional funds from the public. However, part of this increase has financed investments that the Government expects to ultimately recover in whole or in part.

The Government's publicly held debt, or debt held by the public, totaled approximately $7.6 trillion at the end of FY 2009, and was held by the public in the form of Treasury securities, such as bills, notes, and bonds, and accrued interest payable. The 'public' consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Government. Debt held by the public is a balance sheet liability.

In addition to debt held by the public, the Government has outstanding nearly $4.4 trillion in intragovernmental debt, which arises when one part of the Government borrows from another. It represents debt issued by the Treasury and held by Government funds, including the Social Security ($2.5 trillion) and Medicare ($372 billion) trust funds. Intragovernmental debt is primarily held in Government trust funds in the form of special nonmarketable securities by various parts of the Government. Laws establishing Government trust funds generally require excess trust fund receipts to be invested in these special securities. Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated as part of the consolidation process for the governmentwide financial statements (see Note 14 of the Report). When those securities are redeemed, e.g., to pay future Social Security benefits–the Government will need to obtain the resources necessary to reimburse the trust funds.

The sum of debt held by the public and intragovernmental debt equals gross Federal debt, which (with some adjustments) is subject to a statutory ceiling (i.e., the debt limit). Prior to 1917, the Congress approved each debt issuance. In 1917, to facilitate planning in World War I, Congress established a dollar ceiling for Federal borrowing. The statutory limit has been increased roughly 100 times since it was established, and always in time to prevent the United States from defaulting on its debt or other statutory obligations. Congress raised the debt limit twice during FY 2009 – from $10.6 trillion to $11.3 trillion in October 2008 with the passage of the Emergency Economic Stabilization Act of 2008 (EESA), and again to $12.1 trillion in February 2009 with the passage of the American Recovery and Reinvestment Act of 2009 (ARRA). At the end of FY 2009, the amount of debt subject to the limit was $11.9 trillion, $250.9 billion under the limit. In December 2009, the limit was raised to $12.4 trillion, and in February 2010, it was increased again to $14.3 trillion. If overall budget deficits continue, the Government may have to borrow more from the public in order to finance program needs and pay interest on debt held by the public. Instances where debt held by the public increases faster than the economy for extended periods can pose additional challenges.

The Federal debt held by the public as a share of GDP (Chart F above) compares the country's debt level to the size of its economy. Beginning in the late 1970s, increasing budget deficits spurred an increase in debt held by the public, which essentially doubled as a share of GDP over a 15-year period, reaching about 50 percent in 1993. The tax increases and spending reductions instituted by the Congress and the President and reinforced by improved budget enforcement mechanisms, together with economic growth, contributed to declining deficits and emerging surpluses at the end of the 1990s. This improved fiscal performance led to a decline in debt held by the public, (from 43 percent of GDP to about 33 percent from 1998 through 2001). In fiscal years 2002 through 2004, the debt-to-GDP ratio started to rise because of increased spending for homeland security, defense, and wars; a recession-induced decline in receipts; tax cuts; increases in some entitlement benefits; and the expiration of the budget controls established in the late 1990s. The debt held by the public-to-GDP ratio ranged from 35 to 37 percent for most of the last decade. In 2009, the ratio rose to 53 percent, the highest level in nearly 50 years, as the severe economic downturn and the policy measures taken to help the economy caused the unified deficit to rise sharply in 2008 and even more so in 2009.

Statement of Social Insurance – A Current Look at a Possible Future

For the 'social insurance' programs -- Social Security, Medicare, Railroad Retirement, and Black Lung - the Statement of Social Insurance (SOSI) reports: (1) the actuarial present value of all future program revenue (mainly taxes and premiums) - excluding interest - to be received from or on behalf of current and future participants; (2) the estimated future scheduled expenditures to be paid to or on behalf of current and future participants; and (3) the difference between (1) and (2). Amounts reported in the SOSI and in the supplemental information in this report are based on each program's official actuarial calculations. By accounting convention, the general revenues are eliminated in the consolidation of the financial statements at the governmentwide level and as such, the general revenues that are used to finance Medicare Parts B and D are not included in these calculations even though the expenditures on these programs are included.

The SOSI provides perspective on the Government's long-term estimated exposures and costs for social insurance programs. Table 7 summarizes amounts reported in the SOSI. From Table 7, net social insurance expenditures are projected to be approximately $46 trillion as of January 1, 2009 for the 'Open Group'.[7] While these expenditures are not considered Government liabilities, they do have the potential to become expenses and liabilities in the future, based on the continuation of the social insurance programs' provisions contained in current law.

Table 7: Social Insurance Future Expenditures in Excess of Future Revenues

Dollars in Billions		2009		2008	Increase / (Decrease) $	%
Open Group (Net):						
Social Security (OASDI)	$	(7,677)	$	(6,555)	$ 1,122	17%
Medicare (Parts A, B, & D)	$	(38,107)	$	(36,312)	$ 1,795	5%
Other	$	(94)	$	(104)	$ (10)	-9%
Total Social Insurance Expenditures, Net (Open Group)	**$**	**(45,878)**	**$**	**(42,970)**	$ 2,908	7%
Total Social Insurance Expenditures, Net (Closed Group)	**$**	**(52,145)**	**$**	**(49,135)**	$ 3,010	6%

Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)*

Open Group	**2009**	**2008**
Social Security (OASDI)	-1.0%	-0.9%
Medicare (Parts A, B, & D)	-4.8%	-4.6%
Other	0.0%	0.0%
Total (Open Group)	**-5.8%**	**-5.4%**
Total (Closed Group)	**-6.6%**	**-6.2%**

Source: Statement of Social Insurance (SOSI). Amounts equal estimated present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain 'Social Insurance' programs (e.g., Social Security, Medicare). 'Open Group' totals reflect all curent and projected program participants during the 75-year projection period. 'Closed Group' totals reflect only current participants.

* Social Insurance values as reported in the Statement of Social Insurance. GDP values from the 2009 Social Security and Medicare Trust Fund Reports represent the present value of GDP over the 75 year projection period.

Note: totals may not equal sum of components due to rounding.

The social insurance trust funds account for all related program income and expenses. Medicare and Social Security taxes, premiums, and other income are credited to the funds; fund disbursements may only be made for benefit payments and program administrative costs. Any excess revenues are invested in special non-marketable U.S. Government securities at a market rate of interest. The trust funds represent the accumulated value, including interest, of all prior program surpluses, and provide automatic funding authority to pay for future benefits.

The long-run financial condition of Medicare and Social Security is analyzed annually in the Medicare and Social Security Trustees' Reports. Spending on Medicare is projected to rise from its pre-recession level of 3.2 percent of GDP to 6.4 percent in 2030 and 8.7 percent in 2050. Spending on OASDI is projected to rise from 4.4. percent in 2008 to 6.1 percent in 2030, before retreating to 5.8 percent in 2050.[8] Given that revenues for these programs are not projected to rise over time as a share of GDP, it is apparent that these programs are on a fiscally unsustainable path.

The preceding section has focused on the financial results for the Federal Government for FY 2009. The following section discusses the Government's economic recovery efforts and provides additional perspective on the issue of fiscal sustainability.

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[7] 'Closed' Group and 'Open' Group differ by the population included in each calculation. From the SOSI, the 'Closed' Group includes: (1) participants who have attained eligibility and (2) participants who have not attained eligibility. The 'Open' Group adds future participants to the 'Closed' Group. See 'Social Insurance' in the Supplemental Information section in this report for more information.

[8] The Medicare Trustees' Report shows that, under current law, the Hospital Insurance Trust Fund will not have sufficient funds to pay scheduled benefits beginning in 2017. At that point, trust fund income would still be able to cover only 81 percent of scheduled benefits, but this share would fall to about 29 percent in 2083. The Social Security Trust Funds similarly face a long-run shortfall. Under current law, the OASDI Trust Funds will be exhausted in 2037, though revenues would still be sufficient to pay 76 percent of scheduled benefits in 2037 and 74 percent in 2083.

Economic Recovery and Fiscal Sustainability

This section discusses the many important recovery efforts that have been initiated by the Department of the Treasury and across the Government. In addition, while economic recovery is the current priority, this section also addresses the ongoing challenge of sustaining the Nation's important Social Insurance entitlement programs.

The Economy in Fiscal Year 2009

A review of the Nation's key economic indicators can add context to the discussion of the Government's financial results. As summarized in Table 8, the economic recession that began during FY 2008 intensified in the first half of FY 2009. Economic activity contracted sharply in the first two quarters of FY 2009. While economic production began to rise again during the last quarter of the fiscal year, employment continued to fall. By the end of FY 2009, 8 million jobs had been lost since the beginning of the recession.

After showing little change in FY 2008, real GDP growth fell at an annual average rate of 2.6 percent over the four quarters of FY 2009. Quarterly performance was sharply negative in the first and second quarters of FY 2009, with real GDP falling 5.4 percent and 6.4 percent, respectively. However, the pace of contraction eased in the third quarter, and in the final quarter of FY 2009, real GDP grew 2.2 percent at an annual rate.

Table 8: National Economic Indicators*

	FY 2009	FY 2008
Real GDP Growth	-2.6%	0.03%
Residential Construction Growth	-18.9%	-22.6%
Average monthly payroll job change (thousands)	-468	-77
Unemployment rate (percent, end of period)	9.8%	6.2%
Consumer Price Index	-1.3%	4.9%
CPI, excluding food and energy	1.5%	2.5%
Treasury constant maturity 10-year rate (end of period)	3.3%	3.9%
Moody's Baa bond rate (end of period).	6.20%	7.85%

*Some FY 2008 data may differ from FY 2008 Report due to update and revision.

Employment fell throughout FY 2009, although the pace of job losses began to taper off noticeably by the end of the year. Nonetheless, the unemployment rate rose from 6.2 percent in September 2008 to 9.8 percent in September 2009. Consumer price inflation fell, due to declines in energy prices from the previous year's record levels and slack in the economy, as well as slowing growth in food prices. Underlying inflation (the core rate, excluding food and energy) fell. Coupled with modest nominal wage gains, declines in prices produced some of the strongest real wage gains seen since early 1972. The level of corporate profits declined in FY 2009 over the previous fiscal year. On a quarterly basis, however, profits rose in each of the fiscal year's last three quarters after the first quarter's steep decline. Federal tax receipts declined and spending growth accelerated sharply in FY 2009. As a result, the Federal unified budget deficit jumped to $1,417 billion, or about 10 percent of GDP (compared with 3.2 percent in FY 2008).

The following key points summarize economic performance in FY 2009:

- After falling by 0.7 percent in FY 2008, consumer spending declined 0.2 percent over the four quarters of FY 2009, reflecting a mixed pattern of growth during the year, including a 2.8 percent increase in consumption during the final quarter.
- Residential fixed investment fell sharply once again over the four quarters of FY 2009, although a sizable rebound was recorded in the final quarter of the fiscal year. Unlike the previous fiscal year, nonresidential fixed investment also fell, although the pace of decline slowed as the year progressed.
- Labor market conditions deteriorated markedly during much of FY 2009. Nonfarm payroll employment declined at an average rate of 468,000 jobs per month in FY 2009, compared with the 77,000 average increase in jobs per month in FY 2008. From the employment peak in December 2007 through the end of FY 2009, the number of unemployed persons doubled, rising from 7.7 million to 15.2 million in September.
- The pace of job loss slowed over the course of the fiscal year; in the first half, nonfarm payroll employment declined at an average rate of 622,000 jobs per month, versus 314,000 jobs per month in the second half.

- The unemployment rate rose significantly during FY 2009, reaching 9.8 percent at the end of the fiscal year, compared with 6.2 percent at the end of FY 2008.
- The overall price level, as measured by the consumer price index (CPI), fell 1.3 percent during FY 2009 as energy prices retreated after a surge in the prior year. The negative inflation rate in FY 2009 was a stark contrast with the 4.9 percent rise in prices during the 12 months of FY 2008. Core inflation (which excludes food and energy) remained well-contained, slowing to 1.5 percent in FY 2009 versus 2.5 percent in FY 2008.
- Financial market turbulence persisted through the first half of FY 2009, but by fiscal year's end, conditions had stabilized and some measures of financial risk had returned to pre-crisis levels.
    - Corporate debt yields on bonds of moderate risk ballooned to a peak of over 600 basis points above the rate on 10-year Treasury securities in December 2008, compared with a spread of about 300 basis points six months earlier; by September 2009, however, this spread had narrowed to roughly 280 basis points.
    - The difference between the 3-month London Interbank Offered Rate (LIBOR)[9] and the 3-month Treasury rate shot up to a peak of 457 basis points in October 2008 (after averaging less than 50 basis points in 2006 and much of 2007), but had narrowed to less than 20 basis points by the end of September 2009.

The Economic Recovery Effort: The Road to Stability

The severity of the recent financial crisis reflected long-term structural changes that had made the financial system significantly more fragile. Financial intermediation and risk taking grew rapidly in the relatively stable economic environment that preceded the crisis, while rising asset prices hid weak underwriting standards and masked growing leverage throughout the system. Further, risk management systems did not evolve at the pace of financial innovation, which was being driven in part by rapid improvements in information technology. Securitization expanded, allowing for more credit to rely on securities markets. This financial innovation made the system both more interconnected and opaque. The regulatory system was ill-prepared to handle the rapid growth of complex financial activity. In addition, unregulated markets and structures provided an increasing share of short-term credit to fund long-term assets. Such gaps and weaknesses in the supervision and regulation of financial firms presented challenges to the Government's ability to monitor, prevent, or address risks as they built up in the financial system.

Starting in 2007, unanticipated mortgage-related losses weakened the balance sheets of major institutions, thereby reducing their capacity to provide credit and liquidity support to the economy and the rest of the financial system. Given the interconnections throughout the system, problems at individual institutions severely compromised confidence in the system as a whole, both in the United States and abroad. These pressures became acute as FY 2009 approached, as evidenced by the need to put Fannie Mae and Freddie Mac into conservatorship, the failure of Lehman Brothers, and significant problems at American International Group (AIG). In response, the Treasury Department, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and other U.S. government bodies took decisive action to help stabilize financial markets and the nation's economy, and to pull the financial system back from the brink of systemic collapse.

HERA

In July 2008, the Housing and Economic Recovery Act of 2008 (HERA) was enacted. HERA established a new regulatory agency: the Federal Housing Finance Agency (FHFA) with enhanced regulatory authority over the housing Government Sponsored Enterprises (GSEs),[10] including the capital requirements and business activities of Fannie Mae and Freddie Mac. HERA also provided the Treasury Secretary with temporary authority to purchase any obligations and other securities issued by the housing GSEs. FHFA placed Fannie Mae and Freddie Mac under conservatorship in September 2008 in order to preserve GSE assets and restore the GSEs to a sound and solvent financial condition.

Pursuant to HERA, the Treasury Department took three additional steps to help ensure the solvency and liquidity of the GSEs:

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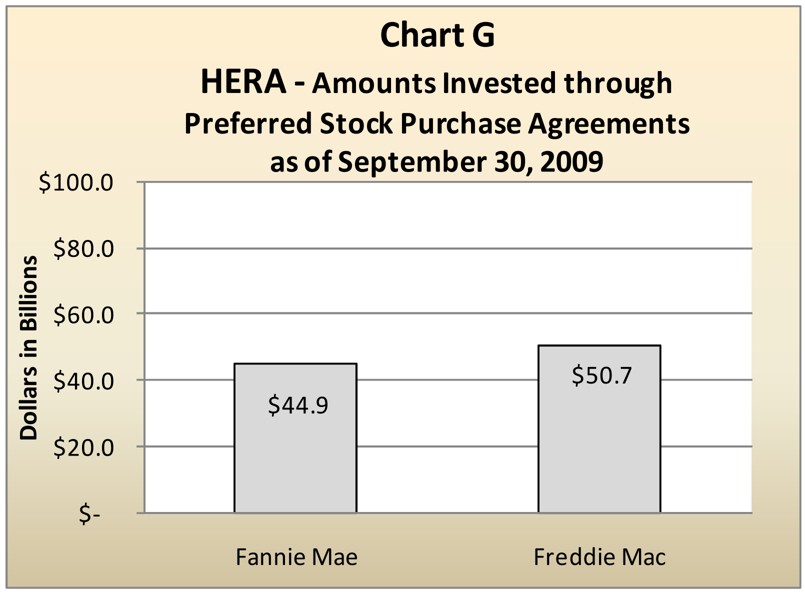
[9] LIBOR is the interest rate at which banks can borrow funds from other banks in the London interbank market. Set daily by the British Bankers' Association, it is the most widely used benchmark for short-term interest rates.

[10] The housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System) are chartered by the Federal Government and pursue a federally mandated mission to support housing finance. Some GSEs are distinctly established as corporate entities - owned by shareholders of stock traded on the New York Stock Exchange. The obligations of the housing GSEs are not guaranteed by the Federal Government, however, Treasury's actions under HERA provided significant financial support to the GSEs.

- entering into senior preferred stock purchase arrangements (SPSPAs) with Fannie Mae and Freddie Mac;
- establishing a GSE credit facility; and
- establishing a GSE mortgage-backed securities (MBS) purchase program.

The SPSPAs enable Treasury to provide the financing necessary for the GSEs to maintain a positive net worth. They were designed to instill confidence in investors that Fannie Mae and Freddie Mac would remain viable entities critical to the functioning of the housing and mortgage markets. Investors purchased securities issued or guaranteed by Fannie Mae and Freddie Mac in part because ambiguities in how they operated (e.g., public mission, line of credit with Treasury, tax exemptions, no SEC filing requirement) created a perception of government backing. These perceptions fostered enormous growth in the obligations issued or guaranteed by Fannie Mae and Freddie Mac which, by the scale and breadth of their public holdings, eventually posed a systemic risk to global financial markets in the event of their failure. The focus of the SPSPAs is to enhance market stability by providing additional confidence to holders of Fannie Mae and Freddie Mac securities and to avoid a mandatory triggering of receivership. Because of the central role of Fannie Mae and Freddie Mac in the housing finance markets and the central importance of the stability of those markets, the U.S. Government had a responsibility to avert the catastrophic failure of these institutions and maintain stability in the housing markets.



The SPSPAs provide that the Government will make funding advances to the GSEs if, at the end of any quarter, the Federal Housing Finance Agency (FHFA), acting as the conservator, determines that the liabilities of either GSE, individually, exceed its respective assets. As shown in Chart G, as of September 30, 2009, actual payments to the GSEs totaled $95.6 billion. In addition, as of September 30, 2009, Treasury accrued $91.9 billion as a liability for liquidity commitments. In May 2009, Treasury's financial liquidity commitment under the SPSPAs was increased from an initial amount of $100 billion per GSE to $200 billion per GSE to provide additional confidence to the financial markets. In December 2009, Treasury announced that it would replace the existing fixed $200 billion per GSE cap with a formulaic cap for the next three years that will adjust upwards quarterly by the cumulative amount of any losses realized by either Fannie Mae or Freddie Mac and downwards by the cumulative amount of any gains, but not below $200 billion per GSE.

The SPSPAs, together with the placement of the GSEs into conservatorship by the FHFA, helped prevent the deteriorating condition of the GSEs from causing a systemic disruption to the housing market and the financial system. The SPSPAs have helped ensure that Fannie Mae and Freddie Mac can continue to fulfill their critical role in the mortgage market by providing liquidity and stabilizing the market. The importance of the GSEs in the mortgage market and overall financial markets has developed over many years, and the Administration is committed to setting forth policies on the future of the GSEs and the Federal Government's role in the mortgage market.

The GSE MBS Purchase Program was created to help support the availability of mortgage credit by temporarily providing additional capital to the mortgage market. By purchasing those securities, Treasury has sought to broaden access to mortgage funding for current and prospective homeowners as well as to promote market stability. As of September 30, 2009, Treasury held about $184.5 billion in GSE MBS during FY 2009 and received back $27.2 billion in principal and interest on GSE MBS it had purchased.[11] This activity, combined with purchases by the Federal Reserve, has helped bring down mortgage rates to historically low levels and provide liquidity and stability to housing markets. The financial support provided by the SPSPAs will continue beyond December 31,

[11] In the first three months of FY 2010, through December 31, 2009, Treasury purchased an additional $29.9 billion in MBS securities, and received back an additional $9 billion in principal and interest. No further purchases were made after December 31, 2009.

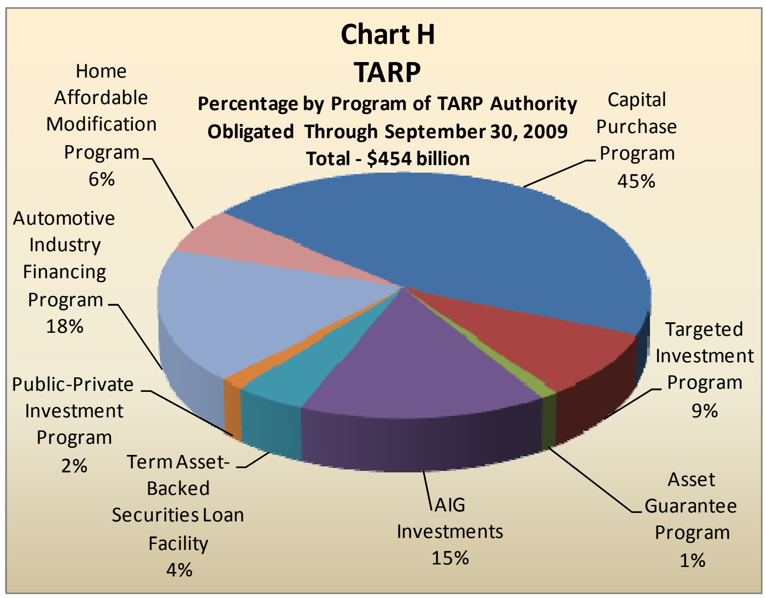
2009. The GSE MBS purchase program and GSE credit facility, established by Treasury under HERA, expired on December 31, 2009.

HERA also established the HOPE for Homeowners Program,[12] which provides another means of helping borrowers faced with foreclosure refinance through the Federal Housing Administration. As the economy continued to suffer during FY 2009 despite these actions, there was still a pressing need to address the more systemic challenges posed by the credit crisis.

EESA, TARP, and the Office of Financial Stability

In the early days of the financial crisis, the Government's policy response was led by the Federal Reserve,[13] and, to a lesser extent, the FDIC. Before September 2008, the Federal Reserve was providing sorely needed liquidity to many financial institutions, which allowed them to meet near-term obligations. The FDIC was insuring deposits, which helped quell bank runs, and it was resolving troubled depository institutions, such as IndyMac. But when stress in the system dramatically intensified in the wake of the Lehman failure, investor confidence collapsed. A different sort of policy response was needed.

The Federal Reserve does not have the authority to directly inject capital into banks and other financial institutions. Although it has expanded the scope of eligible borrowers and collateral over the past few years, the Federal Reserve's liquidity provision is confined to secured lending against good collateral. By comparison, the FDIC has a broader toolset in some respects--including the ability to inject capital or to purchase or guarantee liabilities--but only for depository institutions. This proved to be a stabilizing factor, but in the fall of 2008, the crisis spread well beyond traditional banks. Investors feared that U.S. financial institutions needed, in the aggregate, hundreds of billions of dollars to offset potential credit losses.



In this context, the passage of the Emergency Economic Stabilization Act of 2008 (EESA) and the creation of the Troubled Asset Relief Program (TARP) were essential. EESA gave the Secretary of the Treasury temporary authority to purchase and guarantee assets in a wide range of financial institutions. In addition, the Secretary is directed to ensure that such authorities are used in a manner that protects home values, college funds, retirement accounts, and life savings; preserves homeownership; promotes jobs and economic growth; maximizes overall returns to taxpayers; and provides public accountability. It also provided specific authority to take certain actions to prevent avoidable foreclosures. And finally, it established the Office of Financial Stability in the Department of the Treasury (Treasury-OFS) to oversee and manage the many recovery initiatives and programs.

EESA provided authority for the TARP to purchase or guarantee up to $700 billion of troubled assets.[14] Treasury-OFS used this authority to help strengthen the U.S. financial system, restore health and liquidity to credit markets to facilitate borrowing by consumers and businesses, and prevent avoidable foreclosures in the housing market. While the TARP should be evaluated primarily based on its impact on stabilizing the financial system, a critical factor in the analysis is cost. While EESA authorized Treasury to borrow funds from the public to purchase

[12] HOPE for Homeowners is a voluntary program for the refinancing of distressed loans by providing Federal Housing Administration insurance for refinanced loans that meet certain eligibility requirements. Both borrower and lender must agree to participate in the program.

[13] The Federal Reserve is an independent organization and not considered a part of the Federal reporting entity. As such, their financial results are not consolidated into the Government's financial statements.

[14] The Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, Div. A, amended the EESA and reduced the maximum allowable amount of outstanding troubled assets under the act by almost $1.3 billion, from $700 billion to $698.7 billion.

or guarantee up to $700 billion in troubled assets outstanding at any one time, the TARP has not cost taxpayers $700 billion. Treasury-OFS used the authority to make investments to help stabilize the financial system and expects that much of the funding will be repaid. While some of the TARP investments are likely to result in a cost, others are estimated to produce net income.

It is important to note that much of the discussion in this section relates to TARP activities during fiscal year 2009 and the TARP assets held as of September 30, 2009. Additional information pertaining to material 'subsequent events' is provided in summary fashion in this section and in greater detail in the notes to the financial statements. For FY 2009, Treasury-OFS reports the following key results:

- Treasury-OFS entered into obligations with a face value of $454 billion in TARP authority during the fiscal year.
- In FY 2009, Treasury-OFS disbursed $364 billion in TARP funds to make loans and equity investments, and reported that the net cost of those disbursements, including operating costs, for FY 2009 was about $41.6 billion.
- During FY 2009, Treasury-OFS received about $73 billion in repayments on certain investments made early in FY 2009. Subsequent to September 30, 2009, Treasury has received over $90 billion in additional repayments from TARP participants.
- As of September 30, 2009, Treasury-OFS reported about $240 billion for the value of loans, equity investments, and asset guarantees.

To guide its efforts in implementing and managing the many TARP programs, Treasury-OFS has formulated the following as its operational goals:

1. Ensure the overall stability and liquidity of the financial system, including: (a) making capital available to viable institutions; (b) providing targeted assistance as needed; and (c) increasing liquidity and volume in securitization markets.
2. Prevent avoidable foreclosures and help preserve homeownership.
3. Protect taxpayer interests.
4. Promote transparency.

1. Ensure the Overall Stability and Liquidity of the Financial System

To help ensure the overall stability and liquidity of the financial system, Treasury-OFS developed several programs under the TARP that were broadly available to financial institutions. Under the Capital Purchase Program (CPP), Treasury-OFS provided capital infusions directly to banks and insurance companies deemed viable by their regulators but in need of a stronger asset base to weather the crisis. The Capital Assistance Program (CAP) was developed to supplement the Supervisory Capital Assessment Program (SCAP), or "stress test" of the nineteen largest U.S. bank holding companies (BHCs). The stress test assessed whether these BHCs had the capital to continue lending and absorb all potential losses resulting from a more severe decline in economic conditions than projected by economic forecasters. After completion of the SCAP, the banking agencies concluded that ten of these BHCs needed to raise a total of an additional $75 billion in capital to establish a buffer for more adverse conditions. The remaining nine BHCs were found to have sufficient capital to weather more adverse market conditions. If these institutions were unable to raise adequate private funds to meet the SCAP requirements, Treasury-OFS stood ready to provide additional capital. Treasury-OFS did not receive any applications for CAP, which terminated on November 9, 2009.

In addition, Treasury-OFS provided direct aid to certain financial industry participants through the Targeted Investment Program and the Asset Guarantee Program, as well as the program originally known as the Systemically Significant Failing Institutions (SSFI) program. These programs were designed to mitigate the potential risks to the system as a whole from the difficulties facing these firms. Because SSFI was used only for investments in American International Group, Inc. (AIG), such investments are now referred to as the AIG Investment Program.[15] Similarly, the Automotive Industry Financing Program provided funding for General Motors Corporation (GM), Chrysler LLC (Chrysler), as well as auto financing companies in order to prevent a significant disruption of the automotive industry, which could have negatively affected the economy. As summarized below, Treasury-OFS'

[15] Details on AIG transactions and developments may be found in the notes to the financial statements in this Report. Discussion of developments at AIG before and since this Report may be found in the Treasury Secretary's January 27, 2010 testimony before the House Committee on Government Reform and Oversight at http://www.ustreas.gov/press/releases/tg514.htm

actions helped GM and Chrysler undertake massive and orderly restructurings through the bankruptcy courts, resulting in leaner and stronger companies.

- On December 31, 2008, Treasury-OFS agreed to make loans of $13.4 billion to GM to fund working capital. Under the loan agreement, GM was required to implement a viable restructuring plan by March 30, 2009. The Administration determined that GM's first submitted plan failed to establish a credible path to viability, and the deadline was extended to June 1, 2009. Treasury-OFS loaned an additional $6 billion to fund GM during this period. To achieve an orderly restructuring, GM filed bankruptcy proceedings on June 1, 2009. Treasury-OFS provided $30.1 billion under a debtor-in-possession financing agreement to assist GM through the restructuring period. The new entity, General Motors Company (New GM), purchased most of Old GM's assets and began operating on July 10, 2009. Treasury-OFS converted most of its loans to the Old GM to $2.1 billion of preferred stock and a 60.8 percent share of the common equity in the New GM. Also, New GM assumed $7.1 billion of the Old GM loans due to Treasury-OFS, of which $0.4 billion had been repaid as of September 30, 2009.
- On January 2, 2009, Treasury-OFS loaned $4 billion to Chrysler. On March 30, 2009, the Administration determined that the business plan submitted by Chrysler failed to demonstrate viability and announced that in order for Chrysler to receive additional taxpayer funds, it needed to find a partner with whom it could establish a successful alliance. Chrysler made the determination that forming an alliance with Fiat was the best course of action for its stakeholders. Treasury-OFS continued to support Chrysler as it formed an alliance with Fiat. In connection with Chrysler's bankruptcy proceedings filed on April 30, 2009, Treasury-OFS provided an additional $1.9 billion under a debtor-in-possession financing agreement to assist Chrysler in an orderly restructuring. On June 10, 2009, substantially all of Chrysler's assets were sold to the newly formed entity, Chrysler Group LLC (New Chrysler). Treasury-OFS committed to loan $6.6 billion to New Chrysler in working capital funding, and as of September 30, 2009, New Chrysler had drawn $4.6 billion of this amount. As of September 30, 2009, Treasury-OFS had a $7.1 billion debt security (i.e., $6.6 billion commitment and $0.5 billion of the original $4.0 billion loan assumed by New Chrysler) from and held 9.9 percent of the equity in New Chrysler. The original $4 billion in loans to Chrysler remains outstanding, but has been reduced by $0.5 billion of debt that was assumed by New Chrysler.

The Public-Private Investment Program (PPIP) was established to facilitate price discovery and liquidity in the markets for troubled real estate-related assets as well as the removal of such assets from the balance sheets of financial institutions. In addition to these initiatives, Treasury-OFS implemented the Consumer and Business Lending Initiative (CBLI) to enhance liquidity and restore the flow of credit to consumers and small businesses. The primary program through which the CBLI operated in 2009 was the Term Asset-Backed Securities Loan Facility (TALF). Through this combination of tools, the TARP helped strengthen a broad set of financial institutions and the financial markets.

2. Prevent Avoidable Foreclosures and Help Preserve Homeownership

To prevent avoidable foreclosures and preserve homeownership, Treasury used authority granted under EESA to establish the Home Affordable Modification Program (HAMP) in February 2009. Other government policies have helped keep home mortgage rates at historic lows and allow millions of Americans to refinance and stay in their homes. But because of falling housing prices, many responsible homeowners are unable to refinance. Meanwhile, job losses and reductions in working hours and benefits are making it harder for these Americans to pay their mortgages. HAMP provides incentives to mortgage servicers, investors, and homeowners to work together to reduce an eligible homeowner's monthly payments to levels that are affordable in light of the homeowner's current income.

3. *Protect Taxpayer Interests*

Government financial programs, including TARP, helped prevent a collapse of the U.S. financial system, which could have resulted in much more severe contraction in employment and production. The manner in which TARP was implemented is also designed to protect taxpayers and to compensate them for risk. For example, in exchange for capital injections, recipients of TARP funds have to adhere to corporate governance standards, limit executive pay, and provide additional reporting on lending activity. In addition, Treasury-OFS generally received preferred equity, which provides dividends. The dividend rates increase over time to encourage repayment.

Further, EESA stipulated that the taxpayer benefit as the institutions which received TARP funds recovered. In connection with most investments, Treasury-OFS also receives warrants or additional notes for additional securities in the institutions. This gives taxpayers the ability to share in the potential upside along with existing shareholders. Finally, the Treasury-OFS seeks to achieve the goal of protecting the taxpayer through the effective management and disposition of all TARP investments.

4. *Promote Transparency*

EESA requires transparency and accountability. Specifically, EESA reporting requirements include a monthly report from Treasury-OFS to Congress on TARP activity, a "tranche" report each time Treasury reaches a $50 billion spending threshold, and transaction reports detailing every TARP transaction within two days of the transaction. In carrying out its operations, Treasury-OFS has sought to not only meet the statutory requirements but also to be creative and flexible with respect to additional transparency initiatives. Treasury-OFS proactively provides to the public monthly Dividends and Interest Reports reflecting dividends and interest paid to Treasury-OFS from TARP investments, loans, and asset guarantees, as well as monthly reports detailing the lending activity of participants in the Capital Purchase Program. These reports are all publicly available on *FinancialStability.gov*.

Table 9: Troubled Asset Relief Program (TARP) - Summary
As of September 30, 2009 [1]

Dollars in Billions	Purchase Price or Guaranteed Amounts	Total Disbursed	Investment Repayments	Outstanding Balance	Cash Received From Investments
Capital Purchase Program	$ 204.6	$ 204.6	$ 70.7	$ 133.9	$ 9.7
Targeted Investment Program	$ 40.0	$ 40.0	$ -	$ 40.0	$ 1.9
Asset Guarantee Program	$ 5.0	$ -	$ -	$ -	$ 0.5
AIG Investments	$ 69.8	$ 43.2	$ -	$ 43.2	$ -
Term Asset-Backed Securities Loan Facility	$ 20.0	$ 0.1	$ -	$ 0.1	$ -
Public-Private Investment Program	$ 6.7	$ -	$ -	$ -	$ -
Automotive Industry Financing Program	$ 81.1	$ 75.9	$ 2.1	$ 73.8	$ 0.7
Home Affordable Modification Program[2]	$ 27.1	$ -	N/A	N/A	N/A
TOTALS	**$ 454.3**	**$ 363.8**	**$ 72.8**	**$ 291.0**	**$ 12.7**

[1] This table shows the TARP activity for the period ended September 30, 2009 on a cash basis. Cash received from investments includes dividends and interest income reported on Treasury-OFS' Statement of Net Cost and proceeds from repurchases of warrants and warrant preferred stock (an instrument that Treasury receives from non-publically traded institutions giving Treasury the right to purchase additional preferred shares).

[2] Reflects legal commitments to servicers as of September 30, 2009. Treasury has allocated $50 billion in total for the program. Payments are made to servicers once temporary modifications are made permanent.

Table 9 provides a financial summary for TARP programs in FY 2009. For each program, Table 9 gives the face value of the amount obligated by each program, the amount actually disbursed during the fiscal year, repayments to Treasury-OFS during the period from program participants, net outstanding balance (the amount on the original investment that is due to be repaid to Treasury) on September 30, 2009, and cash inflows on the investments for each program in the form of dividends, interest or other fees.

During the period ended September 30, 2009, the Treasury-OFS disbursed $364 billion, most of it in the form of investments, and $73 billion of those TARP funds have already been repaid as of September 30. As of September 30, 2009, the total amount of investment dollars outstanding for the TARP programs at the end of FY 2009 was about $291 billion. In addition, for the period ended September 30, 2009, the investments generated $12.7 billion in cash received through interest, dividends, and the proceeds from the sale of warrants. For FY 2009, the reported net cost of operations for TARP was approximately $41.6 billion, including administrative expenses.

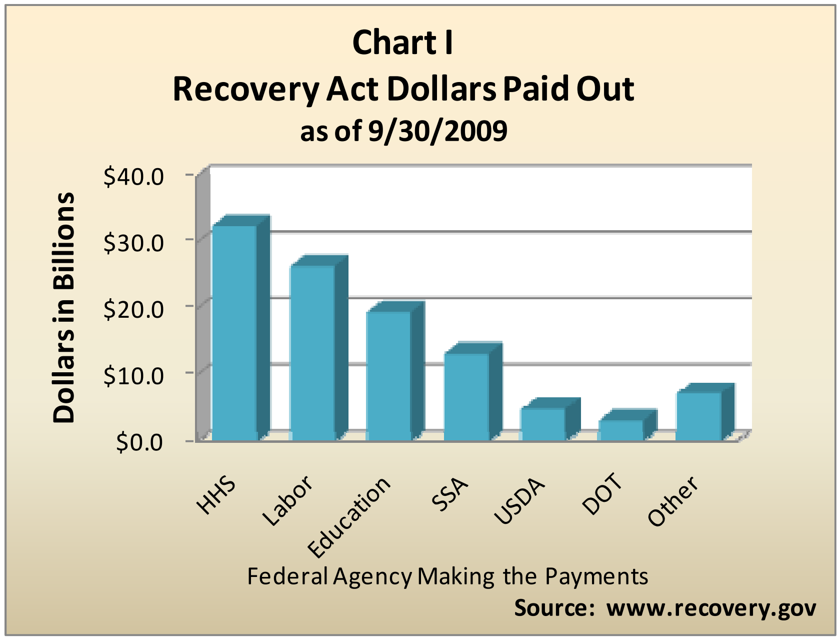
Four TARP programs reported gains in FY 2009: the Capital Purchase Program, the Targeted Investment Program, the Asset Guarantee Program, and the Consumer and Business Lending Initiative. These gains were offset by the net cost of the investments in AIG and the automotive companies, bringing the net cost for these programs during FY 2009 to approximately $41.6 billion. As further disbursements are made in FY 2010 and beyond, the costs of the TARP programs are likely to rise. In particular, the $50 billion Home Affordable Modification Program or "HAMP," is not designed to recoup money spent on loan modifications to keep people in their homes. In addition, the Treasury-OFS' assistance to AIG includes a credit facility on which $27 billion remained undrawn at fiscal year end, and $30 billion of investments and loans under the Public-Private Investment Program will largely be recorded beginning in FY 2010.

Subsequent to September 30, 2009, certain TARP participants have repaid approximately $90 billion to the Treasury and the Asset Guarantee Program was terminated. In December 2009, the Secretary certified the extension of authorities provided under EESA into October 2010.

The ultimate return on the outstanding TARP investments will depend on how the economy and financial markets evolve. Improvement in the economic and financial outlook since the spring of 2009 reflects a broad and aggressive policy response that included the financial stability policies implemented under TARP, efforts to bolster confidence in the housing and mortgage markets under HERA, other financial stability policies implemented by the FDIC and the Board of Governors of the Federal Reserve, accommodative monetary policy, and the American Recovery and Reinvestment Act of 2009.

ARRA

The American Recovery and Reinvestment Act of 2009 (ARRA) was passed by Congress and signed into law by President Obama on February 17, 2009. The purpose of the original $787 billion Recovery package is to jump-start the economy and to create and save jobs. Approximately one-third of ARRA is dedicated to tax cuts for businesses and working families. Another third goes toward emergency relief for those who have borne the brunt of the recession. The final third of the Recovery Act is devoted to investments to create jobs, spur economic activity, and lay the foundation for future sustained growth. ARRA provides for unprecedented levels of transparency and accountability so that the public will know how, when, and where tax dollars are spent.



The website, Recovery.gov, is the centerpiece of the President's commitment to transparency and accountability. It features information on how the Act is working, tools to help hold the government accountable and up-to-date data on the expenditure of funds. It is the main vehicle to provide the public with the ability to monitor the progress of the recovery. Chart I summarizes amounts paid out by Federal agencies as of September 30, 2009. It is important to note that amounts spent by the Federal, State, and Local government agencies, as well as by the private sector are constantly changing. Readers may find the most up-to-date information on where and how these funds are being used at www.recovery.gov.[16]

[16] Amounts in Chart I reflect reported activity as of September 30, 2009. These amounts are not reflected explicitly in agency financial statements and are not audited separately as part of the annual agency or consolidated financial statement audits. For more information, see the Recovery Act website at www.recovery.gov.

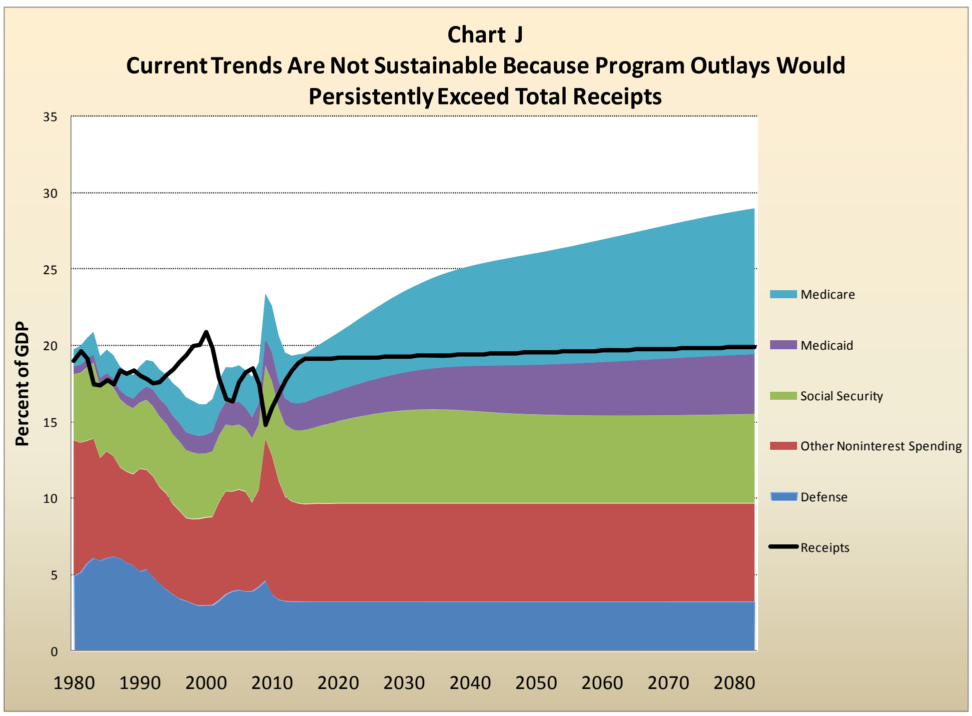
The Long-Term Fiscal Outlook: 'Where We Are Headed'

While the Government's immediate priority is to continue to foster economic recovery, it cannot lose sight of the longer term fiscal challenges, including its continued ability to fund the long-term benefits of critical social programs, including Medicare, Medicaid, and Social Security. Persistent growth of health care costs and the aging of the population, especially the onset of retirement of the 'baby boom' generation, pose significant fiscal challenges.

The Imbalance Between Outlays and Receipts

Spending under current law for Medicare, Medicaid, and Social Security is expected to grow much faster than GDP over the next 75 years as health care costs rise and the population ages. Revenues, on the other hand, are expected to grow only modestly faster than GDP. Together, these two trends imply that without policy changes, the difference between spending and revenues—the budget deficit—will grow as a share of GDP.

Chart J shows historical and estimated program spending and revenue expressed as shares of GDP from 1980 to 2083. Program spending grew rapidly in 2008 and 2009 due to the financial crisis and the recession and the policies necessary to combat both, and is expected to fall in the next few years as the economy recovers. Starting in 2014, however, rising health care costs and the aging population are expected to cause program spending as a share of GDP to rise continuously from 19 percent in 2014 to 25 percent in 2040 and 29 percent in 2080. This reflects the expectation that heath care spending per person will continue to grow faster than will the economy as a whole and the movement of the 78 million 'baby boomers' (those born between 1946 and 1964) from work to retirement.



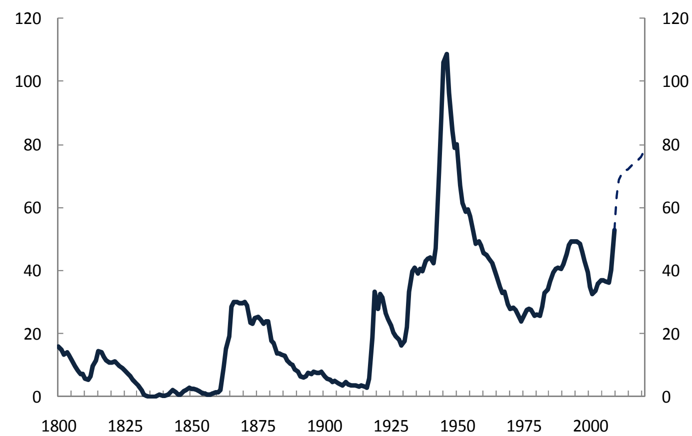
The revenue share of GDP was depressed in 2008 and especially 2009 by the recession and tax changes enacted as part of the 2009 stimulus package. As the economy recovers, the revenue share of GDP is expected to return to historical levels and then grow slightly as increases in real incomes cause larger shares of income to fall into the upper income tax brackets. This extrapolation assumes that Congress and the President will continue to enact legislation that prevents the share of income subject to the Alternative Minimum Tax from rising.

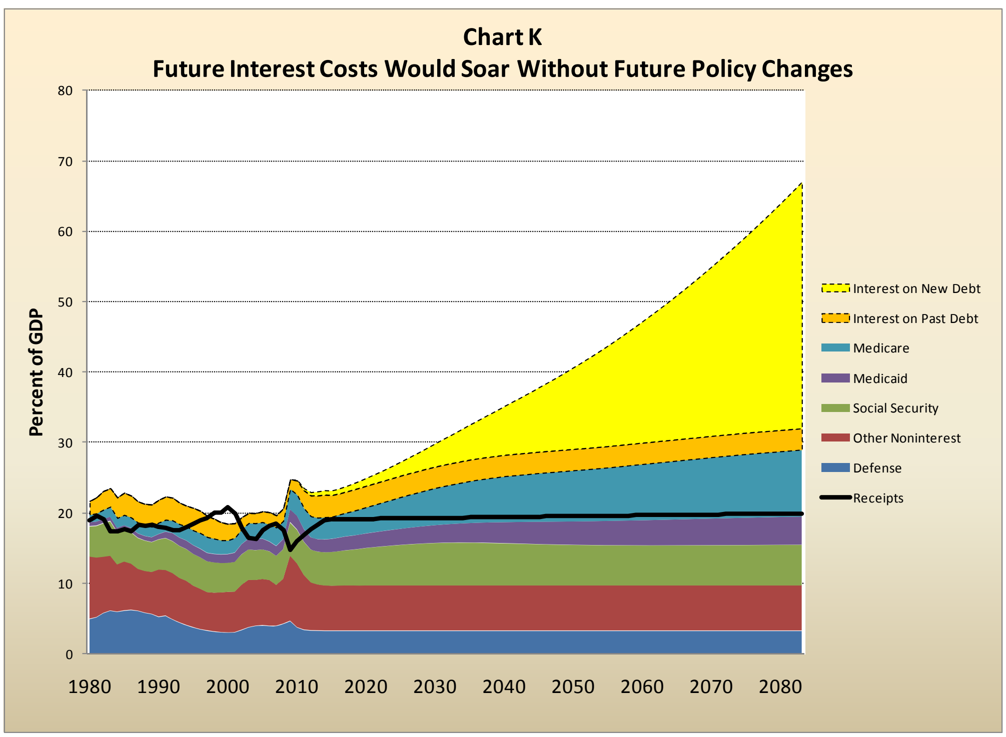
Chart J also illustrates the difference between estimated program spending (spending on mandatory and discretionary programs, excluding interest on debt held by the public) and estimated Government receipts. This difference, known as the primary deficit, is a useful concept because interest spending results from past primary deficits and interest payments on the resulting debt, and can be controlled only through the choice of future primary deficits. To stabilize the debt held by the public-to-GDP (debt-to-GDP) ratio at the projected level of debt-to-GDP when the economy recovers would require roughly a sustained primary balance –a balanced budget excluding interest payments. As such, the chart is also useful for assessing the magnitude of revenue increases or spending reductions that would be necessary to produce fiscal stability.[17] If policy changes are delayed, the magnitude of the policy changes that would be needed to stabilize the debt-to-GDP ratio would be greater.

Net Interest and Debt Held by the Public

Over time, the ratio of Government debt-to-GDP has moved in a wide range (see Figure 1). Before World War I, it was generally below 25% of GDP, and often near zero. But starting with World War I, it grew sharply, reaching 110% of GDP at the end of World War II. The ratio of Government debt -to-GDP came down rapidly in the post-war years, falling below 60% in 1953 and reaching 35% of GDP in 1966. Government debt held by the public grew rapidly from the mid 1970s till the early 1990s. Strong economic growth and fundamental fiscal decisions taken in the early 1990s, including measures to reduce the Federal deficit and implementation of strong "Pay as You Go" ("Paygo") rules, generated a significant reduction in the debt-to-GDP ratio over the course of the 1990s. From a peak of 49 percent of GDP in 1993, the debt-to-GDP ratio fell to 32 percent in 2001. During the last decade, much of this progress was undone as Paygo rules were allowed to lapse, significant permanent tax cuts were implemented, and entitlements were expanded. By September 2008, the debt-to-GDP ratio was 40% of GDP. The extraordinary demands of the current economic and fiscal crisis have pushed up debt held by the public significantly.

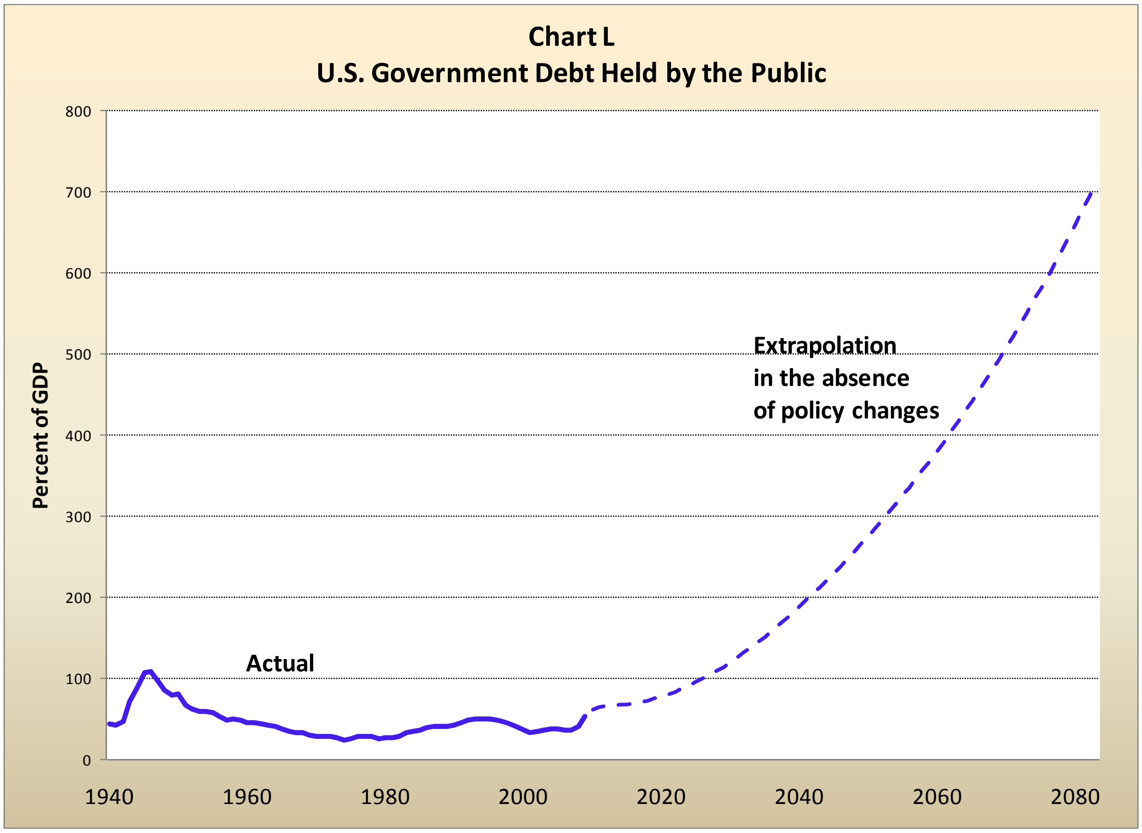
Figure 1: Federal Government Debt (Percent of GDP)





[17] The conditions for a stable debt-to-GDP ratio also depend on the relationship between the interest rate on Government debt and the growth rate of the economy.

Looking forward, in the absence of policy changes, large and growing primary deficits will increase debt held by the public and related interest on that debt. Chart K shows that net interest expressed as a share of GDP could rise from 1.3 percent in 2009 to 10 percent in 2040 and 35 percent in 2080. Because interest expenses grow so rapidly, the total deficit and debt held by the public grow much more rapidly than does the primary deficit. Extrapolating forward, Chart L shows an extrapolation of increases in the outyears in debt held by the public as a share of GDP if policies remain unchanged. These estimates illustrate that current policies are not sustainable.



Financial Management Progress and Priorities

The Office of Federal Financial Management (OFFM) within the Office of Management and Budget (OMB) is responsible for the Federal Government's financial management policy and manages government-wide financial management priorities. As required in the Chief Financial Officers Act (31 U.S.C. 3512), OMB is required to provide an annual report on the status of federal financial management and the goals for improvement.[18] This section summarizes recent progress and outlines several key initiatives intended to achieve improved results moving forward.

Progress To Date

Since the passage of the Chief Financial Officers Act of 1990, the Federal financial community has made important strides in instilling strong accounting and financial reporting practices. Over the past 20 years, an increasing number of Federal agencies have initiated and sustained disciplined and consistent financial reporting operations, implemented effective internal controls around financial reporting, and have successfully integrated transaction processing and accounting records. These efforts have resulted in improved results on financial statement audits, with 20 out of the 24 major "CFO Act" agencies achieving a clean opinion in FY 2009. In addition, the number of auditor-identified material weaknesses stands at 38, an almost 40% decline from the 61 material weaknesses that were identified at the start of this past decade.

A significant accomplishment in FY 2009 was the successful deployment of financial management solutions to meet the emerging challenge of tracking and reporting on economic recovery activities.

- *Troubled Asset Relief Program (TARP)*. In its first full year of operation, the Office of Financial Stability (OFS) within the Treasury Department successfully stood up the necessary financial management solutions to meet the reporting, accounting, and internal control challenges of the complex TARP program. As a result, OFS achieved a clean opinion with no material weaknesses on its first-ever prepared annual financial statements, providing an important indicator to the public that TARP dollars are being effectively accounted for and reported.
- *The American Recovery and Reinvestment Act (ARRA)*. Within days of ARRA's enactment, Federal agencies began successfully reporting weekly updates on ARRA spending on Recovery.gov. In addition, the Federal financial management community partnered with the Recovery Accountability and Transparency Board and other key stakeholders to deploy, within the few short months, a nation-wide data reporting system to collect and report quarterly detailed information on how ARRA dollars are being spent at the local level. Collecting, reviewing, and publishing information on more than 150,000 different awards, the new data collection effort follows Federal dollars in greater depth and detail than previously achieved for most Federal programs.

The foundations for the accomplishments achieved over the past 20 years are numerous. In particular, and as envisioned by OMB Circular A-123, *Management's Responsibility for Internal Control*, the Federal financial management community approached these reporting challenges holistically, integrating both programmatic and financial management disciplines in building successful financial reporting programs. Given the size and complexity of the programs and transactions involved, these results would not have been possible without the advances in Federal financial management.

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[18] The CFO Act requires OMB to submit to Congress an annual "financial management status report," the relevant components of which are included in this Financial Report. Specifically, the "Financial Management Progress and Priorities" section of the MD&A updates and outlines the financial management priorities and planned actions associated with these priorities. Also, specific data on the results of Federal agency financial management efforts (e.g., audit results, material weakness totals, etc.) are included in the Other Accompanying Information Section of this Financial Report.

Ongoing Challenges

Despite the progress identified above, critical gaps in financial management performance remain. Weaknesses in basic financial management practices continue to prevent four major agencies, and the Government as a whole, from achieving a clean audit opinion. The cost of maintaining effective financial operations is increasing, driven largely by the growing and unacceptably high costs agencies are incurring to modernize agency financial systems. While Federal agencies have mobilized resources to meet the new and growing demand for real-time transparency into where recovery-related and other Federal dollars are going, more work is necessary to sustain these solutions in a cost-effective manner over the long term. Federal agencies made nearly $100 billion in improper payments in FY 2009 and continue to maintain thousands of unneeded real property assets on their books. These instances of Government waste compromise the integrity of Federal programs, lead to damaging inefficiencies, and erode citizens' trust in Government.

Improvement Initiatives

It has never been more vital that the Government's financial managers are performing at high levels to meet these challenges and are maximizing the return on every dollar invested in financial management activities. To do so, three areas emerge as the optimal priority areas for the Federal financial management community:

- **Eliminating Waste** – Efforts to cut Government waste should be prioritized through renewed focus and emphasis on eliminating improper payments, removing unneeded real property from the Government's books, and strengthening the audit framework for Federally-funded State and local activities.
- **Closing the Efficiency and Technology Gap in Financial Operations –** Expensive and long-term investments in technology solutions to support financial reporting and accounting must be reconsidered in favor of shorter-term, lower cost, and easier to manage solutions that meet critical business needs, drive operational efficiency, and leverage shared service solutions.
- **Promoting Accountability and Innovation through Open Government** – Efforts should be directed towards improving the content and quality of currently reported information to provide better value to taxpayers and Government decision-makers. Further, solutions must be developed and deployed in partnerships that extend beyond the borders of the Federal financial management community, to involve Federal and State stakeholders, and most critically, members of the public.

Eliminating Waste

- *Addressing Improper Payments.* The Improper Payments Information Act of 2002 (IPIA) created a framework for assessing every Federal program and dollar for risk of improper payments, annually measuring the accuracy of payments, and initiating improvements to ensure that errors are reduced and eliminated. Based on information submitted by agencies in their FY 2009 Performance and Accountability Reports, the Government-wide error rate is five percent or roughly $100 billion. This is the highest amount reported to date, in part due to better controls to identify and report improper payments. In response, the President issued Executive Order 13520, Reducing Improper Payments, to boost transparency of these errors, increase agency accountability through the designation of a Senate-confirmed official responsible for these errors, and create incentives for compliance for contractors and State and Local Government partners. Specifically, agencies will define and publish new metrics to provide information on root causes of error (e.g., Unemployment Insurance recipients that failed to report that they returned to work) and whether corrective actions to reduce errors are successful. Further, we are considering regulatory changes that could allow States that meet established reduction targets retain a portion of recovered improper payments or be subject to relaxed limits on the amount of Federal funds that can be used to cover the State's administrative expenses.
- *Renewing Efforts to Better Manage Federal Real Property*. The Administration is focused on improving the management of real property assets. We support creating incentives to dispose of unneeded Federal real property, including the incentive for all Federal agencies to retain net proceeds from the sale of excess property. In addition to accelerating current effort to dispose of the approximate 15,000 surplus assets on the Federal inventory, new opportunities to make the real property inventory more efficient are also emerging. Under *Executive Order 13514, Federal Leadership in Environmental, Energy, and Economic Performance*, the Federal Government is required to set aggressive goals to "green" the Government and make it more energy

efficient. This order is an opportunity to go beyond "greening" Federal space and take a closer look at opportunities to better optimize the space itself.

- *Improving Grants Management*. Each year, the Federal Government provides over $500 billion in grants to State, local and tribal governments, colleges and universities, and other non-profit organizations –roughly one-sixth of the Federal budget. In 2009, the American Recovery and Reinvestment Act (ARRA) authorized an additional $400 billion in grants to recipients through new ARRA programs and existing programs. In 2009, OFFM initiated a pilot project for an early review and reporting on internal controls for major ARRA programs using the Single Audit process, as required under OMB Circular A-133. This process, along with other efforts to strengthen A-133, is intended to mitigate instances of fraud, waste, abuse, and improper payments in Federal grant programs. We are also committed to working with the grants community to make the grant process efficient and citizen-friendly through streamlining grant applications and reports and modernizing the grants system, Grants.gov.

Closing the Efficiency and Technology Gap in Financial Operations

- *Decreasing the Cost of Financial System Modernizations*. Complexity and inefficiency in our financial management operations has led to an increasingly expensive environment for modernizing financial systems. Also, once deployed, our modern systems do not consistently meet our business needs or produce the right information to support decision-making. By the spring of 2010, OMB will issue new guidelines and strategies for approaching financial system modernizations.
- *Implementing Common Solutions for Financial Management Functions:* New capabilities have emerged to automate and centrally implement financial management activities. For example, through a common electronic vendor invoicing solution, it is possible to input vendor invoice data rather than manually keying the information into a financial system. In the spring of 2010, the Treasury Department will pilot the capture of vendor invoices using a central utility that all agencies could eventually access. This utility will enable a seamless flow of invoice data from entry to payment. The electronic invoicing capability will improve data quality through automation, increase efficiency for agencies that use this service, and vendors to process invoices. Beyond vendor invoicing, the Treasury Department is exploring further opportunities to define common solutions for improved financial operations.

Promoting Accountability and Innovation through Open Government

- *Improving Data Quality for Federal Spending Information.* Agencies have been reporting Federal spending information publicly through the government-wide website – USASpending.gov—since January 2008 pursuant to the Federal Funding Accountability and Transparency Act. The quality of the Federal spending information varies widely and has resulted in some data being missing, erroneous, or otherwise reported untimely. In response, OMB issued the Open Government Directive (Memorandum-10-06) in December 2009, to improve accountability through the designation of a single official within each agency responsible for data quality, and the requirement to implement an internal control environment around Federal spending information. In February, OMB issued a new framework for ensuring the reliability of Federal spending data. This framework heavily relies on agencies' existing internal control programs as required under OMB Circular A-123. Agencies are required to modify and enhance internal controls over Federal spending data to meet the changing environment of disseminating more information to the public at a quicker pace.
- *Partnering For Solutions*. In FY 2010, OMB was appropriated $37.5 million to establish the Partnership Fund for Program Integrity Innovation. The purpose of the Partnership Fund is to improve service delivery, payment accuracy, and administrative efficiency, while reducing access barriers and protecting beneficiaries of federal assistance programs administered by states or localities. The Partnership Fund will allow Federal, State, or local agencies to pilot new ideas in service delivery in a controlled environment with a comprehensive evaluation. Successful pilots could be expanded and used to inform further administrative or legislative action. The partnership will also provide an online clearinghouse for best practices, a collaboration forum, and fund new solutions through grants and other means. The public can contribute innovative approaches and suggestions to reduce improper payments and improve administrative efficiency and service delivery at www.partner4solutions.gov. In spring 2010, the site will be expanded to provide more robust collaboration and search tools, including profiles of best practice innovations.
- *Strengthening the Reporting Model*. The Federal Government's "reporting model" defines the information that is included in federal entity financial statements and other required supplemental information (e.g., Management's Discussion and Analysis) and the scope of internal controls related to financial reporting. Inclusion in the financial statements or required supplemental information also affects the nature and extent of

the auditor's responsibilities. The overall goal of this initiative is to maintain public faith and confidence in Federal financial management by proposing improvements to the usefulness of financial reports to decision makers and the public and strengthening audit requirements on areas where financial risks are the most significant. Particular emphasis is being placed on obtaining improved information on the cost of Government activities and the results achieved. OMB, working with the CFO Council, will put forward a new, proposed framework for financial reporting by the spring of 2010. At that time, OFFM will initiate a dialogue with interested stakeholders (Congress, GAO, the Federal Accounting Standards Advisory Board, the Council of Inspectors General on Integrity and Efficiency (CIGIE), etc.) to validate and refine proposals to improve the reporting model, and propose an implementation plan for deploying the new model.

The sweeping challenges we face in the Government today require our financial managers to move beyond the status quo and to generate a higher return on investment for our financial management activities. The steps outlined above leverage the tools and capacities in place today, but refocus energies on critical and emerging priorities – cutting wasteful spending, improving the efficiency of our operations and information technology, and laying a foundation for data quality and collaboration as we enter a new era of transparency and open Government.

Additional Information

This *Financial Report's* Appendix contains the names and websites of the significant Government entities included in the Report's financial statements. Details about the information in this *Financial Report* can be found in these entities' financial statements included in their Performance and Accountability and Annual Financial Reports. This *Financial Report*, as well as those from previous years, is also available at the Treasury, OMB, and GAO websites at: http://www.fms.treas.gov/fr/index.html; http://www.whitehouse.gov/omb/financial/index.html; and www.gao.gov, respectively. Other related Government publications include, but are not limited to the:

- *Budget of the United States Government*,
- *Treasury Bulletin*,
- *Monthly Treasury Statement of Receipts and Outlays of the United States Government*,
- *Monthly Statement of the Public Debt of the United States*,
- *Economic Report of the President*, and
- *Trustees' Reports* for the Social Security and Medicare Programs.

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