# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Introduction

The fiscal year (FY) *2010 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 strengthen 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 individual agency and governmentwide reporting deadlines.

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 thirteen years, a "disclaimer" of opinion on the accrual-based consolidated financial statements for the fiscal years ended September 30, 2010 and 2009. Additionally, GAO issued a disclaimer of opinion on the 2010 and 2006 Statement of Social Insurance (SOSI). A disclaimer of opinion indicates that sufficient information was not available for the auditors to determine whether the reported financial statements were fairly presented. GAO issued unqualified opinions on the 2009, 2008, and 2007 Statements of Social Insurance. In FY 2010, 28 of the 35 most significant agencies earned unqualified opinions on their financial statement audits.[1]

The FY 2010 *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 position and condition.

## 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 affordable 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.

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

[1] The Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Farm Credit System Insurance Corporation (FCSIC) are among the 35 significant entities. However, because these entities operate on a calendar year basis (December 31 year end), their 2010 audits are not yet complete.

# Exhibit 1

## THE UNITED STATES GOVERNMENT

### THE CONSTITUTION

### LEGISLATIVE BRANCH

**THE CONGRESS**
**SENATE HOUSE**

Architect of the Capitol
United States Botanic Garden
Government Accountability Office
Government Printing Office
Library of Congress
Congressional Budget Office
U.S. Capitol Police

### EXECUTIVE BRANCH

**THE PRESIDENT**
**THE VICE PRESIDENT**
**EXECUTIVE OFFICE OF THE PRESIDENT**

White House Office
Office of the Vice President
Council of Economic Advisers
Council on Environmental Quality
National Security Council
Office of Administration
Office of Management and Budget
Office of National Drug Control Policy
Office of Policy Development
Office of Science and Technology Policy
Office of the U.S. Trade Representative

### JUDICIAL BRANCH

**THE SUPREME COURT OF THE UNITED STATES**

United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims

Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission

### SIGNIFICANT REPORTING ENTITIES

- DEPARTMENT OF AGRICULTURE
- DEPARTMENT OF COMMERCE
- DEPARTMENT OF DEFENSE
- DEPARTMENT OF EDUCATION
- DEPARTMENT OF ENERGY
- DEPARTMENT OF HEALTH AND HUMAN SERVICES
- DEPARTMENT OF HOMELAND SECURITY
- DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
- DEPARTMENT OF THE INTERIOR
- DEPARTMENT OF JUSTICE
- DEPARTMENT OF LABOR
- DEPARTMENT OF STATE
- DEPARTMENT OF TRANSPORTATION
- DEPARTMENT OF THE TREASURY
- DEPARTMENT OF VETERANS AFFAIRS

### OTHER SIGNIFICANT REPORTING ENTITIES

ENVIRONMENTAL PROTECTION AGENCY
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
NATIONAL SCIENCE FOUNDATION
OFFICE OF PERSONNEL MANAGEMENT
SMALL BUSINESS ADMINISTRATION
SOCIAL SECURITY ADMINISTRATION
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
U.S. NUCLEAR REGULATORY COMMISSION
EXPORT-IMPORT BANK OF THE UNITED STATES

FARM CREDIT SYSTEM INSURANCE CORPORATION
FEDERAL COMMUNICATIONS COMMISSION
FEDERAL DEPOSIT INSURANCE CORPORATION
NATIONAL CREDIT UNION ADMINISTRATION
PENSION BENEFIT GUARANTY CORPORATION
RAILROAD RETIREMENT BOARD
SECURITIES AND EXCHANGE COMMISSION
SMITHSONIAN INSTITUTION
TENNESSEE VALLEY AUTHORITY
U.S. POSTAL SERVICE

OTHER ENTITIES ARE LISTED IN APPENDIX A OF THIS REPORT

# 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 and as summarized in Table 1, 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 and premiums, 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 ongoing economic recovery efforts 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 | | 2010 | | 2009 |
|---|---|---|---|---|
| Gross Cost | $ | (4,472.3) | $ | (3,735.6) |
| Less: Earned Revenue | $ | 309.2 | $ | 300.9 |
| (Loss)/Gain from Changes in Assumptions[1] | $ | (132.9) | | n/a |
| **Net Cost of Operations** | **$** | **(4,296.0)** | **$** | **(3,434.7)** |
| **Less: Taxes and Other Revenue:** | $ | 2,216.5 | $ | 2,198.4 |
| Unmatched Transactions & Balances | $ | (0.8) | $ | (17.4) |
| **Net Operating Cost[2]** | **$** | **(2,080.3)** | **$** | **(1,253.7)** |
| **Assets[3]:** | | | | |
| Cash & Other Monetary Assets | $ | 428.6 | $ | 393.2 |
| Loans Receivable and Investments, Net[4] | $ | 942.5 | $ | 843.3 |
| Property, Plant & Equipment, Net | $ | 828.9 | $ | 784.1 |
| Other | $ | 683.8 | $ | 647.3 |
| **Total Assets** | **$** | **2,883.8** | **$** | **2,667.9** |
| **Liabilities[3]:** | | | | |
| Federal Debt Held by the Public | $ | (9,060.0) | $ | (7,582.7) |
| Federal Employee & Veterans Benefits | $ | (5,720.3) | $ | (5,283.7) |
| Other | $ | (1,576.3) | $ | (1,257.4) |
| **Total Liabilities** | **$** | **(16,356.6)** | **$** | **(14,123.8)** |
| **Net Position (Assets minus Liabilities)** | **$** | **(13,472.8)** | **$** | **(11,455.9)** |
| **Social Insurance Net Expenditures[5]:** | | | | |
| Social Security (OASDI) | $ | (7,947) | $ | (7,677) |
| Medicare (Parts A, B, & D) | $ | (22,813) | $ | (38,107) |
| Other | $ | (97) | $ | (94) |
| **Total Social Insurance Net Expenditures** | **$** | **(30,857)** | **$** | **(45,878)** |
| **Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)[6]** | | | | |
| Social Security (OASDI) | | -0.9% | | -1.0% |
| Medicare (Parts A, B, & D) | | -2.7% | | -4.8% |
| Other | | 0.0% | | 0.0% |
| **Total Net Expenditures as % of GDP** | | **-3.7%** | | **-5.8%** |

1 Separate reporting of these amounts was initially required in FY 2010.

2 Source: Statements of Operations and Change in Net Position.

3 Source: Balance Sheet

4 Includes Loans Receivable and Mortgage-Backed Securities, Troubled Asset Relief Program (TARP) Investments, and Investments in Government-Sponsored Enterprises (GSEs).

5 Source: Statements 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 - Black Lung is projected through 2040). Amounts reflect 'Open Group' totals (all current and projected program participants during the 75-year projection period).

6 Social Insurance values as reported in the Statement of Social Insurance. GDP values from the 2010 Social Security and Medicare Trustees 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:

- Government primarily cash-based outlays of $3.5 trillion, net of receipts of $2.2 trillion (approximately 24 percent and 15 percent of GDP, respectively) yielded a unified budget deficit for FY 2010 of slightly under $1.3 trillion.[2]
- The Government borrows from the public to finance the gap between cash-based outlays and receipts and to finance certain cash transactions that are not reflected in the deficit. For FY 2010, debt held by the public, including accrued interest totaled approximately $9.1 trillion (62 percent of GDP).
- 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, are, absent policy changes, projected to exceed dedicated receipts for these programs by almost $31 trillion (nearly 3.7% of GDP over the 75-year period)[3], a $15 trillion decline from net expenditures of $46 trillion projected in the 2009 Report. Much of this decrease is attributable to estimated effects of the Affordable Care Act (ACA) on the Medicare program. Medicare Parts B and D are primarily financed by general revenues. By accounting convention, general revenues are eliminated in consolidation at the governmentwide level and, as such, are not included in this calculation.

## Fiscal Year 2010 Financial Statement Audit Results

For FY 2010, the Government Accountability Office (GAO) issued a disclaimer of audit opinion on the accrual-based Governmentwide financial statements for the fourteenth consecutive year. In addition, GAO issued a disclaimer of opinion on its audit of the 2010 and 2006 Statement of Social Insurance (SOSI). GAO had issued unqualified opinions on the 2009, 2008, and 2007 SOSI. GAO disclaimed an opinion on the 2010 SOSI because of significant uncertainties (discussed in note 26), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2010 SOSI.

Twenty of the 24 agencies required to issue audited financial statements under the Chief Financial Officers (CFO) Act received unqualified audit opinions (Table 2), as did eight of 11 additional significant reporting agencies, as listed in Appendix A.

**Table 2: Summary of FY 2010 Financial Statement Audit Results by Agency**

| CFO Act Agencies | FY 2010 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) | Disclaimer |
| Department of Justice (DOJ) | Unqualified |
| Department of State (State) | Unqualified |
| 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) | Qualified |
| 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 |

* HHS received a disclaimer of opinion on its 2010 Statement of Social Insurance.

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

[2] Final Monthly Treasury Statement (as of September 30, 2010).

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

## The Governmentwide Reporting Entity

These financial statements 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 and U.S. Capitol Police (legislative branch agencies) 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, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Government increased its investment in the recovery effort in FY 2009 under the Emergency Economic Stabilization Act (EESA), which gave the Secretary of the Treasury temporary authority to purchase and guarantee assets from a wide range of financial institutions. Following U.S. Generally Accepted Accounting Principles (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, the entities in which the Federal Government holds equity investments 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. However, the investments in these entities and any related liabilities are recorded in the financial statements. A list of the significant agencies and entities contributing to this report is included in Appendix A.[4]

### 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 and the financial condition of its social insurance programs, 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 Government's financial results for FY 2010, the budget, the economy, the debt, the Government's ongoing economic recovery efforts, and a long-term perspective about fiscal sustainability, including the Government's ability to meet its social insurance benefits obligations. 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.

# 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 GAAP for Federal entities.[5] 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. Also, unique to Government is the preparation of

[4] 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 each agency's financial report.

[5] 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.

separate statements to reconcile differences and articulate the relationship between the budget and financial accounting results.

| President's Budget | Financial Report of the U.S. Government |
|---|---|
| Prepared primarily on a "*cash basis*"<br>• Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them.<br>• Receipts ("cash in"), taxes and other collections recorded when received.<br>• Outlays ("cash out"), largely recorded when payment is made. | Prepared on an "*accrual and modified cash basis*"<br>• Agency-based and retrospective – prior and present resources used to implement initiatives.<br>• 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.<br>• Costs: recognized when owed, but not necessarily paid. |

Note – See Statements of Changes in Cash Balance from Unified Budget and Other Activities and Reconciliations of Net Operating Cost and Unified Budget Deficits.

## Budget Deficit vs. Net Operating Cost

As the economy continues along a path of gradual recovery, the Government's primarily cash-based[6] budget deficit decreased slightly, from $1.4 trillion to $1.3 trillion, following significant deficit increases during FY 2008 and especially FY 2009 due to the impacts of the financial crisis and recession and the policy actions taken in response. This increase was attributable in part to Government programs that act as "automatic stabilizers," which help 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. These automatic stabilizers, in addition to recent economic recovery efforts, caused the deficit to surge in recent years. However, the deficit decreased in the past year due to slight increases in cash tax receipts and a decline in outlays.

**Table 3: Budget Deficit vs. Net Operating Cost**

| Dollars in Billions | 2010 | 2009 | $ Change |
|---|---|---|---|
| **Net Operating Cost** | **$ (2,080.3)** | **$ (1,253.7)** | **$ (826.6)** |
| Change in: | | | |
| Liabilities for Veteran's Compensation | $ 223.8 | $ (149.2) | $ 373.0 |
| Liabilities for Military and Civilian Employee Benefits | $ 279.3 | $ 114.0 | $ 165.3 |
| Liabilities for Government Sponsored Enterprises | $ 268.0 | $ 78.1 | $ 189.9 |
| Downward Reestimate for TARP | $ 86.4 | $ (110.0) | $ 196.4 |
| Other, Net | $ (71.3) | $ (96.3) | $ 25.0 |
| **Budget Deficit** | **$ (1,294.1)** | **$ (1,417.1)** | **$ 123.0** |

Source: Statements of Reconciliations of Net Operating Cost and Unified Budget Deficit

The Government's largely accrual-based net operating cost (which increased from an already record high of about $1.3 trillion in FY 2009 to nearly $2.1 trillion in FY 2010) typically exceeds the deficit due largely to the inclusion of cost accruals such as those for estimated future postemployment benefit liabilities. Table 3 shows the primary differences between the budget deficit and net operating cost in FY 2010. The majority of the differences stem from changes in liabilities associated with the Government's postemployment programs for its military and civilian employees ($279.3 billion), as well as its veterans ($223.8 billion). The longer-term actuarial costs of these programs are included in the Government's net operating cost, calculated on an accrual basis as described above, but not in the largely cash-based budget deficit. Agencies and their actuaries estimate their liability for these benefits over the long-term, but funds have yet to actually be spent. As will be discussed further in the following section, a new accounting standard effective for FY 2010 requires agencies to more clearly indicate the impact that changes in assumptions have on their overall net costs. Similarly, Table 3 shows that another significant difference is the $268 billion increase in estimated long-term liabilities associated with the continued support of Government-Sponsored Enterprises, such as Fannie Mae and Freddie Mac under agreements with them.

[6] Interest outlays on Treasury debt held by the public are recorded in the budget when interest accrues, not when the interest payment is made. For Federal credit programs, outlays are recorded when loans are disbursed, in an amount representing the present value cost to Government (excluding administrative costs), or the credit subsidy cost. Credit programs record cash payments to and from the public in nonbudgetary financing accounts.

# 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, deficits, and debt. 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 accrual-based net position is the difference between its assets and liabilities. The Government's "bottom line" net operating cost is the difference between its revenues and costs.

## 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.

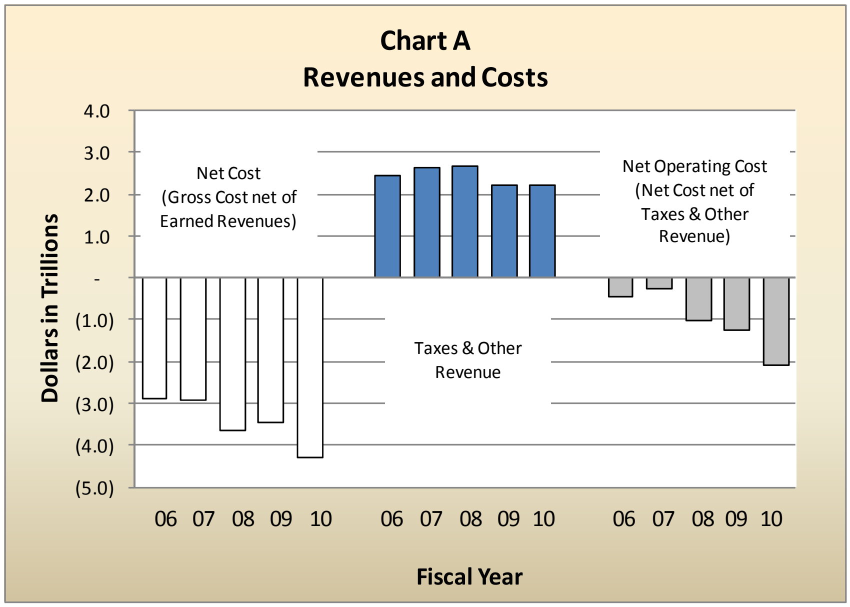



Chart A and Table 4 show that the Government has incurred a total net operating cost (i.e., costs have exceeded its revenues) over the past several years, causing net position to decline. In summary, Table 4 shows that during FY 2010, the Government's "bottom line" net operating cost of $2,080.3 billion increased by two-thirds or $827 billion over 2009's net operating cost of $1,253.7 billion. This significant increase was attributable almost entirely to a nearly 25 percent increase in net cost as taxes and other revenues were nearly identical to last year.

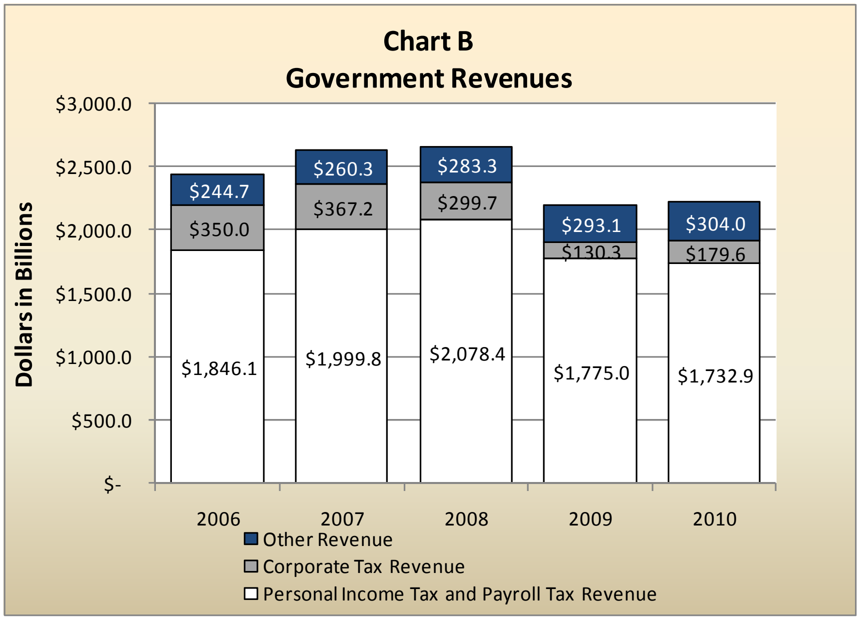
**Table 4: Gross Cost, Revenues, and Net Cost**

| Dollars in Billions | | 2010 | | 2009 | Increase / (Decrease) $ | | % |
|---|---|---|---|---|---|---|---|
| **Gross Cost** | **$** | **(4,472.3)** | **$** | **(3,735.6)** | | | |
| (Loss)/Gain from Changes in Assumptions | $ | (132.9) | | n/a | | | |
| **Adjusted Gross Cost*** | **$** | **(4,605.2)** | **$** | **(3,735.6)** | $ | 869.6 | 23.3% |
| Less: Earned Revenue | $ | 309.2 | $ | 300.9 | $ | 8.3 | 2.8% |
| **Net Cost of Operations (Net Cost)** | **$** | **(4,296.0)** | **$** | **(3,434.7)** | $ | 861.3 | 25.1% |
| Less: Taxes and Other Revenue | $ | 2,216.5 | $ | 2,198.4 | $ | 18.1 | 0.8% |
| Unmatched Transactions and Balances | $ | (0.8) | $ | (17.4) | $ | 16.6 | 95.4% |
| **Net Operating Cost** | **$** | **(2,080.3)** | **$** | **(1,253.7)** | $ | 826.6 | 65.9% |

* Starting in FY 2010, agencies were required to separately display costs attributable to gains/losses from assumption changes associated with postemployment programs. Adjusted Gross Cost is shown separately above to establish a consistent basis of comparison with FY 2009.

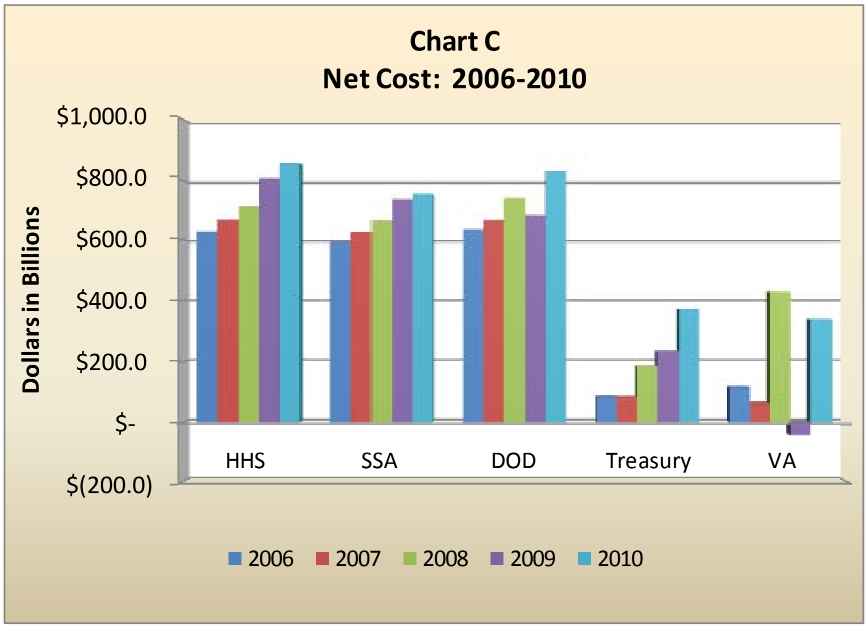
The ***Reconciliation of Net Operating Cost and Unified Budget Deficit Statement*** shows how the Government's net operating cost from the primarily accrual-based financial statements relates to the more widely-known and primarily cash-based budget deficit. As summarized in Table 3 on the previous page, most of this difference is attributable to cost related to changes in the estimated present value of the Federal Government's net postemployment liabilities. The impact of these accrual costs is more evident starting in FY 2010 with the issuance of a new federal accounting standard[7], requiring agencies to explicitly report on gains and losses attributable to changes in actuarial assumptions. These actuarial amounts are presented in Table 4 and discussed further in this section.

### Revenue: "What Came In"




The ***Statement of Net Cost*** reports "earned" revenue generated by Federal programs, including Medicare 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, at just over $2.2 trillion, total Government revenues in FY 2010 were nearly identical to FY 2009, increasing by about $18.1 billion, as the economy continues to recover. Corporate tax revenue rebounded from a more than 50 percent decline in FY 2009 to increase by nearly 40 percent during FY 2010. However, in dollar terms, the $49.3 billion corporate tax increase and a slight increase in other tax revenue was partially offset by a slight decrease (2.4 percent or $42.1 billion) in personal income tax revenue to keep total revenues relatively stable. Together, personal and corporate income taxes accounted for more than 86 percent of total revenues in FY 2010.

### 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* or the difference between: (1) the costs of goods produced and services rendered by the Government and (2) the earned revenues generated by those goods and services 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*.

Chart C shows the cost trends in the entities that contributed the most to the Government's total net cost (gross cost less earned revenue) of $4,296.0 billion in FY 2010 (a 25 percent or $861.3 billion increase over FY 2009). The Department of Health and Human Services (HHS), the Department of Defense (DoD), and the Social Security Administration (SSA) have

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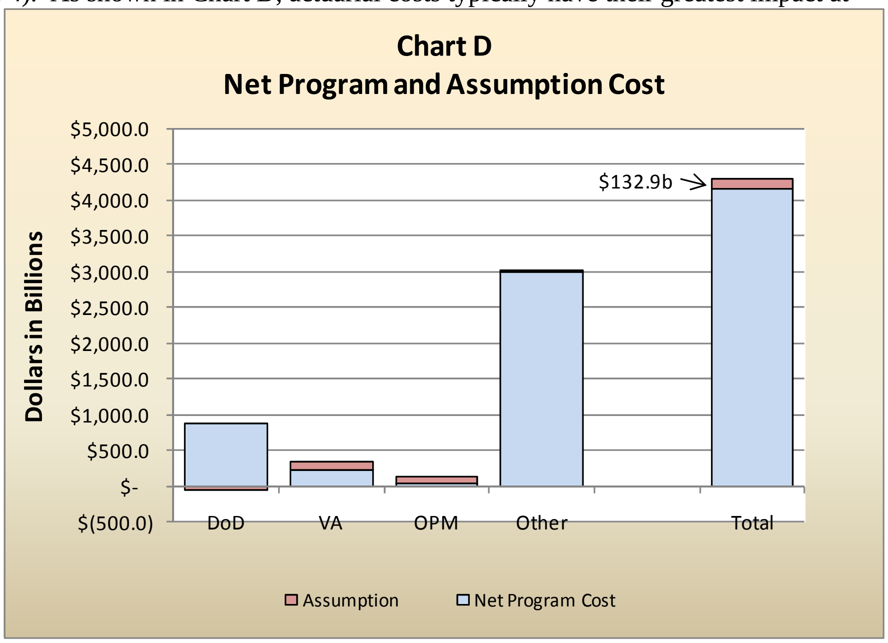
[7] Statement of Federal Financial Accounting Standard 33, '*Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from the Changes in Assumptions and Selecting Discount Rates and Valuation Dates.*

consistently incurred the largest agency shares of the Government's total net cost of operations in recent years, combining to comprise almost 60 percent of the Government's FY 2010 total net cost. The bulk of HHS and SSA costs (which totaled $857.6 billion and $753.9 billion, respectively in FY 2010) are attributable to major social insurance programs administered by these agencies, e.g., Medicare and Social Security. 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 and the longer-term costs of military retirement and health benefits. These long-term "actuarial" costs also represented a significant portion of costs at the Department of Veterans Affairs (VA), relating to VA's veterans' benefits programs. Chart C also shows the Department of the Treasury as a significant contributor to the Government's net cost in FY 2010, due in large part to costs associated with the ongoing economic recovery efforts discussed later.

As indicated above, the actuarial and other estimated costs associated with the Government's postemployment benefits programs for its military and civilian employees represent a significant portion of total costs for a few select agencies, including VA, DoD, and the Office of Personnel Management (OPM). In the aggregate, just the change in actuarial and other estimated costs associated with the change in estimated postemployment benefit liabilities (see Table 3), accounted for more than $538 billion or 62 percent of the total change in the Government's net cost of $861.3 billion for FY 2010 (Table 4). As shown in Chart D, actuarial costs typically have their greatest impact at the VA, DoD, and OPM corresponding to those agencies' administration of the Government's pension and other postemployment benefits programs. These agencies employ a complex series of assumptions, including but not limited to interest rates, inflation, beneficiary eligibility life expectancy, and cost of living to make annual actuarial projections of their long-term benefits liabilities and the related costs. Annual changes in these assumptions can cause those projections, and consequently total costs, to fluctuate, sometimes significantly, from year to year. For example, as illustrated in Chart C, at VA alone, assumption and experience changes resulted in a $373 billion increase in VA's and the Governmentwide Net Cost, following more than $480 billion decrease the previous year. The $373 billion increase for VA reflects an increase in actuarial costs at VA from ($149.2) billion in FY 2009 to $223.8 billion in FY 2010 as indicated in Table 3.




As indicated earlier, a new accounting standard not only requires discrete presentation of actuarial gains and losses, but also prompts the use of a more standardized approach to discount rates and valuation dates in an attempt to mitigate the volatility in the effect of these assumptions in recent years. Chart D shows that actuarial gains and losses from changes in assumptions accounted for a net $132.9 billion of the Government's total net cost and illustrates the varying impact that these assumptions can have. The extent to which normalization occurs will become evident after successive years of use of the new standard.

As noted earlier, taxes and other revenues of $2,216.5 billion are deducted from the Government's total net cost of $4,296.0 billion (including actuarial costs) to derive a "bottom line" net operating cost (including a slight adjustment for unmatched transactions and balances as described in the Required Supplementary Information section of this Report). As previously shown in Table 4, the relatively unchanged taxes and other revenues, combined with the nearly 25 percent increase in net costs, resulted in a "bottom line" net operating cost of about $2.1 trillion ($2,080.3 billion) for FY 2010, an increase of 66 percent or $827 billion over the FY 2009 net operating cost of about $1.3 trillion.

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

As indicated earlier, net position at the end of the year is derived by netting the Government's assets against its liabilities, as presented in the ***Balance Sheet*** (summarized in Table 5). 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 is 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 later in this MD&A section as well as in the supplemental disclosures of this Report.

**Table 5: Assets and Liabilities**

| Net Position<br>Dollars in Billions | 2010 | 2009 | Increase (Decrease) $ | Increase (Decrease) % |
|---|---|---|---|---|
| **Assets** | | | | |
| Cash & Other Monetary Assets | $ 428.6 | $ 393.2 | $ 35.4 | 9.0% |
| Loans Receivable and Investments, Net* | $ 942.5 | $ 843.3 | $ 99.2 | 11.8% |
| Inventories | $ 286.2 | $ 284.6 | $ 1.6 | 0.6% |
| Property, Plant & Equipment, Net | $ 828.9 | $ 784.1 | $ 44.8 | 5.7% |
| Other | $ 397.6 | $ 362.7 | $ 34.9 | 9.6% |
| **Total Assets** | **$ 2,883.8** | **$ 2,667.9** | **$ 215.9** | **8.1%** |
| **Less: Liabilities, comprised of:** | | | | |
| Federal Debt Held by the Public | $ (9,060.0) | $ (7,582.7) | $ 1,477.3 | 19.5% |
| Federal Employee & Veterans Benefits | $ (5,720.3) | $ (5,283.7) | $ 436.6 | 8.3% |
| Other | $ (1,576.3) | $ (1,257.4) | $ 318.9 | 25.4% |
| **Total Liabilities** | **$ (16,356.6)** | **$ (14,123.8)** | **$ 2,232.8** | **15.8%** |
| **Net Position**<br>(Assets Minus Liabilities) | **$ (13,472.8)** | **$ (11,455.9)** | **$ (2,016.9)** | **-17.6%** |

*Includes Net Loans Receivable and Mortgage-Backed Securities, Troubled Asset Relief Program (TARP) Investments, and Investments in Government-Sponsored Enterprises (GSEs).

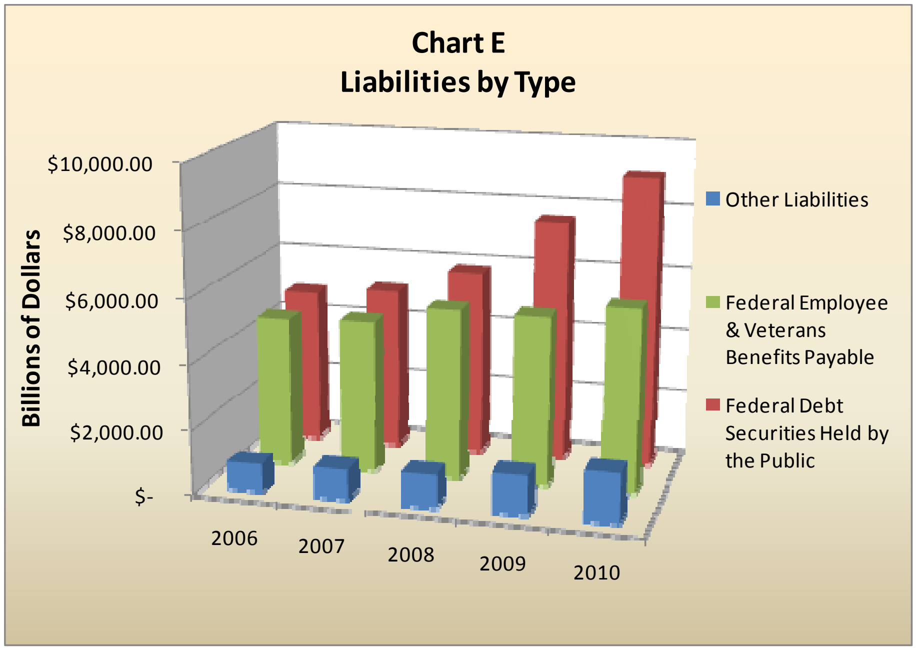
### Assets – "What We Own"

As of September 30, 2010, the Government held about $2.9 trillion in assets, comprised mostly of net property, plant, and equipment ($828.9 billion in FY 2010) and a combined total of $942.5 billion in net loans receivable and investments, including nearly $145 billion associated with the Troubled Asset Relief Program (TARP) efforts and $109 billion in Government-Sponsored Enterprises (GSEs) investments in (GSEs and TARP not shown separately in Table 5). During FY 2010, the Government's total assets increased by $215.9 billion, due in large part to the nearly $100 billion increase in Net Loans Receivable and Investments as economic recovery efforts continued. On September 17, 2008, the Department of the Treasury and the Federal Reserve announced the Supplementary Financing Program (SFP) - a temporary program to help the Federal Reserve in funding its authorized expenditures under its liquidity and lending initiatives aimed at addressing the ongoing crisis in financial markets. As of September 30, 2010, $200 billion or nearly half of the Government's $428.5 billion cash balance was associated with this program, compared to $165 billion as of September 30, 2009. 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"

As indicated in Table 5 and Chart E, the Government's largest liability is Federal debt held by the public and accrued interest, the balance of which increased to $9.1 trillion during FY 2010.

The other major component of the Government's liabilities is Federal employee postemployment and veteran benefits payable, which increased $436.6 billion during FY 2010, from $5,283.7 billion to $5,720.3 billion. As indicated earlier, this increase was due to increases in future benefit liability estimates made by VA ($223.8 billion increase), DoD ($164.2 billion), and OPM and other agencies administering Federal civilian pension plans ($115.1 billion). OPM administers the largest civilian pension plan, covering nearly 2.8 million current employees[8] and 2.5 million annuitants.[9] The military pension plan covers over 3.1 million current military personnel (including active service, reserve, and National Guard) and approximately 2.2 million retirees and annuitants.[10]




## Federal Debt

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 publicly held debt, or debt held by the public, including accrued interest, totaled approximately $9.1 trillion at the end of FY 2010 – an increase of nearly $1.5 trillion. 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 imply. Each year, trillions of dollars of debt matures and new debt takes its place. In FY 2010, new borrowings were $8.5 trillion and repayments of maturing debts held by the public were $7.1 trillion. Both represented slight decreases over new borrowings and debt repayments for FY 2009, respectively.

Historically, the Government has incurred debt when it borrows from the public to finance budget deficits. The economic recovery efforts of the past two years have precipitated a need to borrow additional funds from the public. However, as will be discussed later, part of this increase has financed investments on which the Government has already made significant recovery.

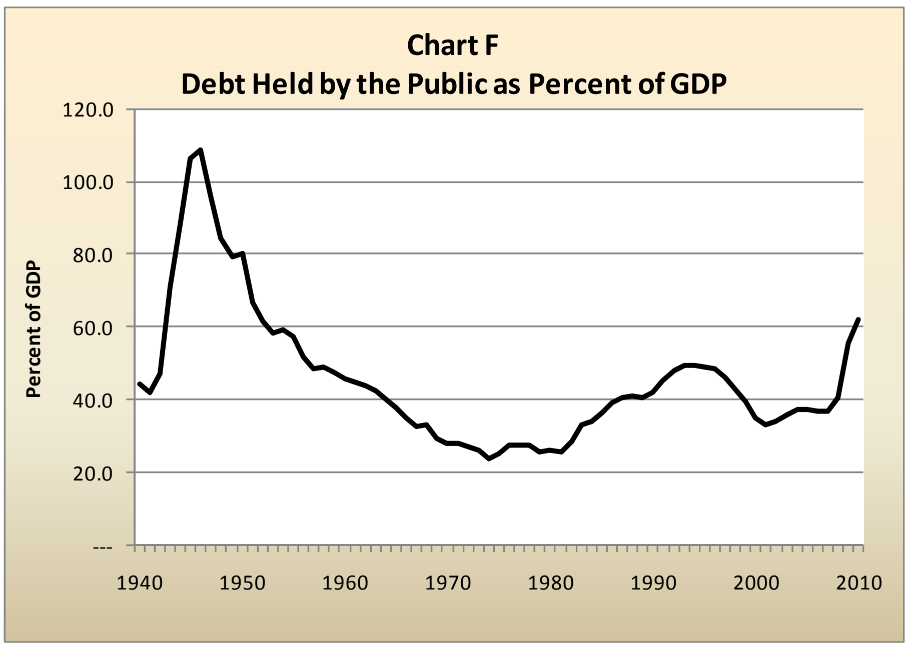
Debt was held by the public in the form of Treasury securities, such as bills, notes, and bonds, and accrued interest payable. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Government. Debt held by the public is a balance sheet liability.

In addition to debt held by the public, the Government has outstanding nearly $4.6 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 accounts, including the Social Security ($2.6 trillion) and Medicare ($350.5 billion) trust

[8] As of 9/30/2009 OPM Office of Actuaries.
[9] OPM FY 2010 Annual Financial Report, p. 9.
[10] DoD FY 2010 Agency Financial Report, p. 8; DoD Military Retirement Fund (MRF) financial statements, p. 10.

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 (including interest earnings) 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. At the end of FY 2010, the amount of debt subject to the limit was $13.5 trillion, $783 billion under the current limit. The debt limit has been raised multiple times in recent years. In December 2009, the limit was raised to $12.4 trillion, and in February 2010, it was increased again to $14.3 trillion, where it remains as of September 30, 2010. If overall budget deficits continue, the Government will 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 measured as a percent of GDP compares the country's debt to the size of its economy. Over time, the ratio of Federal debt-to-GDP has varied widely. For most of the Nation's history, the debt to GDP ratio has tended to increase during wartime and decline during peacetime. That pattern continued to hold following World War II until the 1970s. As shown in Chart F, wartime spending and borrowing had pushed the debt to GDP ratio to an all-time high of 109% in 1946, but the ratio came down rapidly in the post-war years. It fell to 80 percent by 1950 and 46% in 1960. The postwar low point was reached in 1974 at 24 percent. Since then, Federal debt held by the public as a percent of GDP has increased. It grew rapidly from the mid 1970s until the early 1990s. In the 1990s, strong economic growth and fundamental fiscal decisions, including measures to reduce the Federal deficit and implementation of binding "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 1993-1994, the debt-to-GDP ratio fell to 33 percent in 2001. During the last decade, much of this progress was undone as PAYGO rules were allowed to lapse, significant 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 recent economic and fiscal crisis and ensuing recovery have pushed up debt held by the public to nearly 53 percent in 2009 and 62 percent in 2010.

The preceding section has focused on the financial results for the Federal Government for FY 2010. The following sections discuss the Government's economic recovery efforts and as well as perspective on the issue of fiscal sustainability.

# Economic Recovery Efforts

This section provides an overview of the Economy at the end of FY 2010 and discusses the many important recovery efforts that have been initiated by the Department of the Treasury and across the Government.

## The Economy in Fiscal Year 2010

**Table 6: National Economic Indicators***

| | FY 2010 | FY 2009 |
|---|---|---|
| Real GDP Growth | 3.2% | -2.7% |
| Residential Construction Growth | -5.6% | -21.4% |
| Average monthly private payroll job change (thousands) | 58 | -528 |
| Unemployment rate (percent, end of period) | 9.6% | 9.8% |
| Consumer Price Index | 1.1% | -1.3% |
| CPI, excluding food and energy | 0.8% | 1.5% |
| Treasury constant maturity 10-year rate (end of period) | 2.5% | 3.3% |
| Moody's Baa bond rate (end of period). | 5.6% | 6.2% |

*Some FY 2009 data may differ from the FY 2009 Report due to update and revision.

A review of the Nation's key macroeconomic indicators can help place the discussion of the Government's financial results in a broader context. As summarized in Table 6, the economy began to grow again during FY 2010, after emerging in FY 2009 from the longest and deepest recession since World War II. During the recession, which began in December 2007 and ended in June 2009, payrolls fell by 7.3 million. Although employment rose during FY 2010, the unemployment rate remained relatively high.

After falling by 2.7 percent during FY 2009, real GDP rose at an annual average rate of 3.2 percent over the four quarters of FY 2010. Quarterly performance was comparatively strong during the first and second quarters of FY 2010, with real GDP rising 5.0 percent and 3.7 percent, respectively. The pace of expansion slowed during the latter half of the fiscal year, and in the final quarter, real GDP grew 2.5 percent at an annual rate. The economy added nearly 691,000 private nonfarm payroll jobs during FY 2010, after losing 6.3 million private jobs during FY 2009. The unemployment rate remained high during FY 2010, edging down from 9.8 percent in September 2009 to 9.6 percent in September 2010. After declining outright in the previous fiscal year, consumer price inflation increased, mostly due to rising energy prices, but remained in check. Underlying inflation (the core rate, excluding food and energy) slowed to roughly half the rate of the previous fiscal year. Real wages rose, but at a much slower pace than the previous fiscal year's strong gains, reflecting the combination of slower nominal wage growth and rising consumer prices. The level of corporate profits rose in FY 2010 after declining in each of the three previous fiscal years, although on a quarterly basis, growth was faster during the first half of the year than the latter half. Federal tax receipts rose and spending growth declined in FY 2010. As a result, the Federal unified budget deficit narrowed to $1,294 billion, or 8.9 percent of GDP (compared with 10 percent in FY 2009).

The following key points summarize economic performance in FY 2010:

- After falling 0.9 percent in FY 2009, consumer spending advanced 2.0 percent over the four quarters of FY 2010, reflecting a rising pattern of growth over the year, including an increase of 2.8 percent during the final quarter.
- Residential construction fell by 5.6 percent over the four quarters of FY 2010, although in the fiscal year's third quarter, this component surged by nearly 26 percent, as activity increased in connection with the first time homebuyer's tax credit. Nonresidential fixed investment grew 8.3 percent, after declining by almost 18 percent in the previous fiscal year.
- Labor market conditions improved slowly over the course of FY 2010. Nonfarm private payroll employment increased at an average rate of 58,000 jobs per month in 2010, compared with the 528,000 average decline in private payroll jobs per month in FY 2009. During FY 2010, the number of unemployed persons fell from 15.2 million to 14.8 million.

- The pace of job creation or loss fluctuated over the course of the fiscal year; in the first half, total nonfarm payroll employment fell at an average rate of 1,000 jobs per month, versus an average rate of increase of 80,000 jobs per month in the second half, with much of the fluctuation due to movements in temporary Census Bureau jobs related to the 2010 Census.
- The unemployment rate peaked at 10.1 percent in October 2009, a 26-year high, and gradually declined to a low of 9.5 percent in June and July 2010, before edging higher to 9.6 percent during the last two months of the fiscal year, just 0.2 percentage points lower than the rate at the end of FY 2009.
- The overall price level, as measured by the consumer price index (CPI), rose 1.1 percent during FY 2010, as energy prices increased. In FY 2009, the CPI had declined by 1.3 percent, reflecting outright declines in energy prices. Core inflation (which excludes food and energy) remained very well-contained, slowing to 0.8 percent in FY 2010 from 1.5 percent the previous fiscal year.
- Financial markets conditions and measures of financial risk generally remained stable in FY 2010.
    - Corporate debt yields on bonds of moderate risk stood at about 290 basis points above the rate on 10-year Treasury securities at the end of FY 2009. After narrowing to about 240 basis points mid-way through FY 2010, this spread widened again to 305 basis points by the end of the fiscal year.
    - The difference between the 3-month London Interbank Offered Rate (LIBOR) and the 3-month Treasury rate stood at 15 basis points at the end of FY 2009. After widening to nearly 50 basis points in June, the spread narrowed again, to end the fiscal year at 13 basis points.

## The Economic Recovery Effort

In mid-September 2008, the Nation was in the midst of one of the worst financial crises in our history. The economy was contracting sharply. Fear of a possible depression froze markets. Immediate, strong action was needed to avoid a complete collapse of the financial system. The Department of the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and other U.S. Government bodies undertook an array of unprecedented steps at that time to avert a collapse and continue to administer a number of programs to pave the way for sustained economic recovery.

**HERA**

The Housing and Economic Recovery Act of 2008 (HERA) established a new regulatory agency, the Federal Housing Finance Agency (FHFA), to regulate the housing Government-Sponsored Enterprises (GSEs),[11] Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. FHFA placed Fannie Mae and Freddie Mac under conservatorship in September 2008 in order to preserve GSE assets and restore those 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:

- 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 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. These agreements provide that the Government will make funding advances to the GSEs if, at the end of any quarter, the FHFA, acting as the conservator, determines that the liabilities of either GSE, individually, exceed its respective assets. 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 maximum amount available to each GSE under this agreement was originally $100 billion and in May 2009 was raised to $200 billion. In December 2009, Treasury amended the SPSPAs to replace the existing $200 billion per GSE funding commitment 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 GSE and downward by the cumulative amount

[11] 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 Fannie Mae and Freddie Mac.

of any gains, but not below $200 billion per GSE, and will become fixed at the end of the three years, December 31, 2012. At the conclusion of the three-year period, the remaining commitment will then be fixed and available to be drawn per the terms of the agreements. As of September 30, 2010, Treasury's cumulative payments to Fannie Mae and Freddie Mac were $85.1 billion and $63.1 billion, respectively, and a combined $359.9 billion has been accrued as a contingent liability. The losses the GSEs continue to report are largely the result of delinquencies and defaults on loans that were originated and guaranteed in 2006, 2007, and 2008. Less than one percent of losses have come from loans originated in 2009 and 2010.

The U.S. Government's investment in and support of the GSEs through the SPSPAs was structured in such a way that virtually all profits in the companies revert to the Government in the form of dividends on the preferred shares in Fannie Mae and Freddie Mac. To get a true picture of the Government's exposure in the companies, it is critical to factor in those dividends and net them against the draws that the companies make from Treasury. For instance, while for FY 2010, the GSE's draws exceeded dividends by $40.5 billion, in the quarter ending September 30, 2010, the Government received more in dividend payments than the companies drew from the Treasury SPSPAs.[12]

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. In total, the Treasury Department purchased MBS worth approximately $225.5 billion, $29.9 billion of which were purchased in FY 2010. In total, Treasury has received back $61.1 billion in principal and $13.9 billion in interest from MBS holdings. As of September 30, 2010, the valuation of MBS held under HERA programs was $172.2 billion. 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 GSE MBS purchase program and GSE credit facility expired on December 31, 2009.

HERA also established the HOPE for Homeowners Program,[13] which provides another means of helping borrowers faced with foreclosure to refinance through the Federal Housing Administration.

**EESA, TARP, and the Office of Financial Stability**

The Emergency Economic Stabilization Act of 2008 (EESA) provided authority and facilities that the Secretary of the Treasury could use to restore liquidity and stability to the financial system of the United States, and ensured that such authority and facilities have been used in a manner that protected home values, college funds, retirement accounts, and life savings; preserved home ownership; promoted jobs and economic growth; maximized overall returns to the taxpayers of the United States; and provided public accountability for the exercise of such authority.

The EESA authorized the establishment of the Office of Financial Stability (Treasury-OFS) within the Office of Domestic Finance of the Treasury Department to implement the Troubled Asset Relief Program (TARP). TARP, in conjunction with other Federal Government actions, helped to unfreeze capital and credit markets, bringing down the cost of borrowing for businesses, individuals, and state and local governments, restoring confidence in the financial system, and restarting economic growth. TARP did so faster and at a much lower cost than anticipated.

The EESA provided authority for the TARP to purchase or guarantee up to $700 billion in troubled assets. 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. In December 2009, the Secretary of the Treasury certified the extension of TARP authority from its original termination date of December 30, 2009 until October 3, 2010. The Secretary identified two principal objectives for the extension of TARP — to preserve capacity to respond to unforeseen threats to financial stability and to address continuing challenges — and indicated that Treasury-OFS did not expect to use more than $550 billion of the $700 billion authorized by Congress. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act reduced the cumulative authority to $475 billion. Many of the investments under the program, particularly those aimed at stabilizing banks, have thus far delivered positive returns for taxpayers.

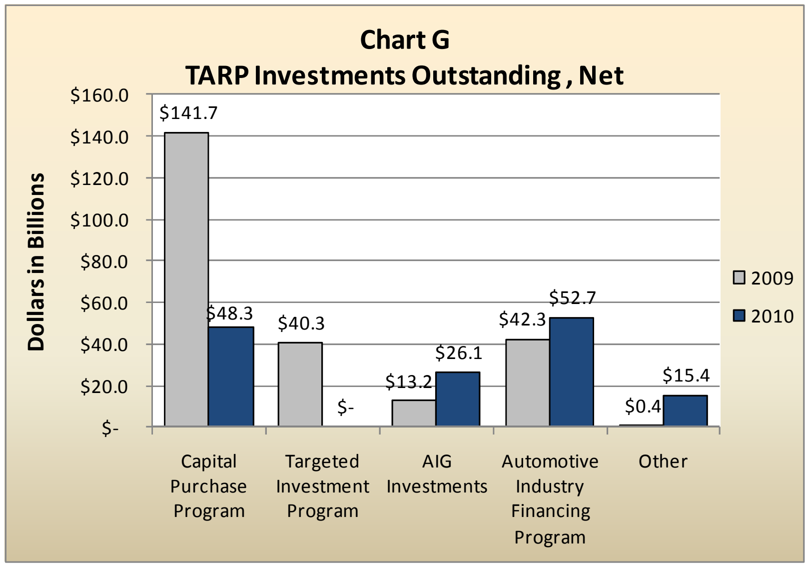
Due to improved market conditions, lower utilization of the program, and careful stewardship, the expected cost of TARP over its lifetime continues to decline on a budget basis, from $341 billion in the August 2009 Midsession

[12] Department of the Treasury FY 2010 Performance and Accountability Report, p. 21.

[13] 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.

Review of the President's 2010 Budget (assuming the full $700 billion of TARP was utilized) to $117 billion in the FY 2011 President's Budget released in February 2010 (assuming $546 billion of $700 billion TARP authority was utilized), to possibly less than $50 billion, if a proposed restructuring of AIG, as mentioned below, is completed as announced. Under the proposed restructuring, Treasury would receive 1.1 billion shares of AIG common stock in exchange for its TARP investment. This cost is based on the October 1, 2010 market price, but actual proceeds from any future sale would be based on the market price at the time of sale, which could differ materially from the October 1, 2010 market price. Treasury would receive an additional 563 million shares from the trust established by the Federal Reserve Bank of New York (FRBNY). It should be noted that the budget-basis lifetime cost of TARP differs from the cost reflected in the financial statements in that lifetime costs assume that all planned expenditures are made, whereas financial statement costs are based only on transactions through September 30, 2010. As such, the cost of TARP since inception as reported in the financial statements was $18.5 billion, consisting of $23.1 billion of reported TARP net income for FY 2010 and $41.6 billion of reported net cost for FY 2009.

Chart G shows how TARP's net investments have changed during FY 2010. Since its inception through September 30, 2010, Treasury disbursed $387.7 billion in direct loans and investments. Over half ($204.1 billion) of those TARP funds have been repaid, and the investments generated $27.8 billion from cash received through interest and dividends, as well as proceeds from the sale and repurchase of assets in excess of cost. As of September 30, 2010, TARP had $179.2 billion in gross outstanding direct loans and equity investments, valued at $142.5 billion.




Treasury is moving quickly to recover the Government's investments. The Department aims to dispose of its investments as quickly as practicable, consistent with the duty to promote financial stability and to protect taxpayers' interests.

- Treasury continues to carefully manage TARP assets and has recovered more than 75 percent of TARP funds provided to banks, principally through the Capital Purchase Program (CPP). These capital support programs are expected to deliver returns for taxpayers.
- Treasury is beginning to recover investments in the auto industry. General Motors Company (GM) has repaid its remaining outstanding loan balance and recently agreed to repurchase the preferred stock issued to Treasury. In addition, as a result of GM's initial public offering, in November 2010, Treasury received approximately $13.5 billion in net proceeds and reduced its equity stake in GM from 60.8 percent to 33.3 percent. The ultimate loss estimate on investments in Chrysler and Ally Financial, Inc (formerly GMAC) is expected to be less than last year.
- The restructuring plan announced by AIG on September 30, 2010, assuming it is completed as announced (closing remains subject to contingencies), will accelerate the timeline for repaying the Federal Government and put taxpayers in a considerably stronger position to recoup Treasury investments in the company. Giving effect to the September 30, 2010, announced restructuring of the AIG investments, including the Treasury's beneficial interest in the AIG Trust, the Treasury would realize a positive return on the AIG investment on a pro forma basis considering the AIG common stock price as of October 1, 2010. On December 8, 2010, the parties entered into a master transaction agreement that supersedes, but does not represent a material departure from, the terms contained in the September 30 AIG restructuring agreement.

Treasury also expanded its housing programs under TARP, launching the Housing Finance Agency (HFA) Innovation Fund for the Hardest Hit Housing Markets (HHF) to help state housing finance agencies provide additional relief to homeowners in the states hit hardest by unemployment and declines in home prices. In addition, Treasury and the Department of Housing and Urban Development (HUD) enhanced the FHA Refinance program to enable homeowners whose mortgages exceed the value of their homes to refinance into more affordable mortgages if their lenders agree to reduce the unpaid principal balance by at least ten percent.

Finally, it should be noted that the TARP cost estimates are only estimates, based on current market prices where available. Since market prices change, such estimates will change. The ultimate cost of the outstanding TARP investments is, therefore, subject to significant uncertainty and will depend on, among other things, how the economy, financial markets, and particular companies perform. Additional information concerning the TARP program and other related initiatives can be found at www.financialstability.gov.

**The Recovery Act**

Improvement in the economic and financial outlook since the spring of 2009 reflects a broad and aggressive policy response that included the initiatives and programs under HERA and TARP as discussed above, 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 or the Recovery Act). The purpose of the original $787 billion ARRA 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 is devoted to investments to create jobs, spur economic activity, and lay the foundation for future sustained growth. Cumulative ARRA amounts paid out by Federal agencies as of September 30, 2010 totaled $307.9 billion, as compared to $110.7 billion as of September 30, 2009.[14] 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

# The Long-Term Fiscal Outlook: "Where We Are Headed"

While the Government's immediate priority is to continue to foster economic recovery, there are longer term fiscal challenges that must ultimately be addressed. Persistent growth of health care costs and the aging of the population due to the retirement of the 'baby boom' generation and increasing longevity will make it increasingly difficult to fund critical social programs, including Medicare, Medicaid, and Social Security.

## Fiscal Sustainability

An important purpose of the Financial Report is to help citizens and policymakers assess whether current fiscal policy is sustainable and, if it is not, to highlight the urgency and magnitude of policy reforms necessary to make it sustainable. A sustainable policy is one where the ratio of debt held by the public to Gross Domestic Product (the debt–to-GDP ratio) is stable in the long run. Sustainability concerns only whether long-run revenues and expenditures are in balance; it does not concern fairness or efficiency implications of the reforms necessary to achieve sustainability.

To determine if current fiscal policies are sustainable, the projections discussed here assume current policies will be sustained indefinitely and draw out the implications for the growth of debt held by the public as a share of GDP. The projections are therefore neither forecasts nor predictions. If policy changes are enacted, perhaps in response to projections like those presented here, then the projections will of course prove to be untrue.

The projections in this Report indicate that the trajectory of current policy is not sustainable. If current policies are kept in place indefinitely, the debt to GDP ratio is projected to exceed 350 percent in 2085 and to rise continuously thereafter. Closing the gap between spending and receipts over the next 75 years (the "75-year fiscal gap") is estimated to require some combination of spending reductions and revenue increases that amount to 2.4 percent of GDP over the period. While the precise size of the fiscal gap is highly uncertain, there is little question that current fiscal policies cannot be sustained indefinitely.

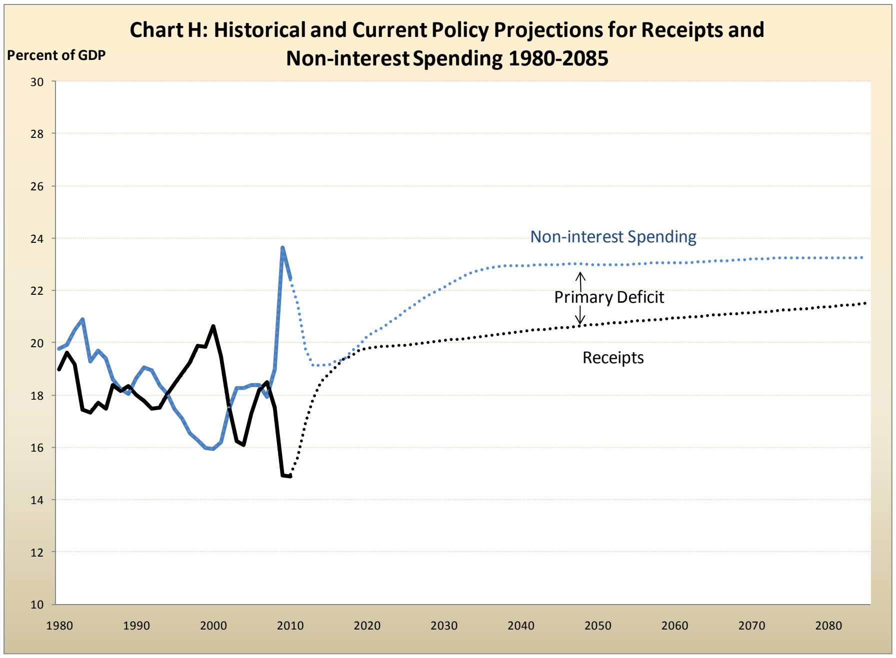
It is important to address the Nation's fiscal imbalances soon. Delaying action increases the magnitude of spending reductions and/or revenue increases necessary to stabilize the debt-to-GDP ratio. For example, it is

[14] Agency Financial & Activity Reports as of September 30, 2010 and 2009. For more information, see the Recovery Act website at www.Recovery.gov.

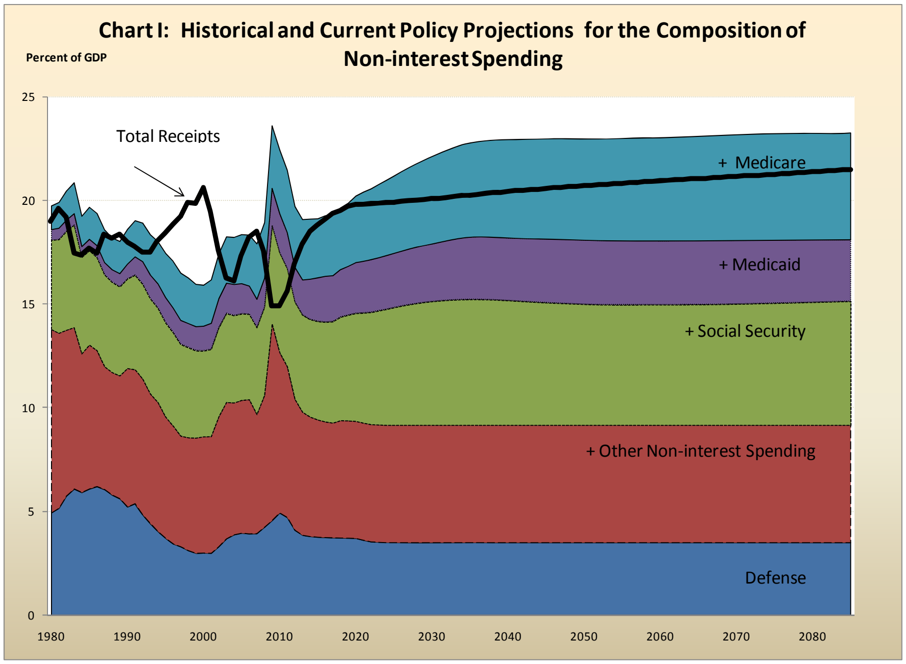
estimated that the magnitude of reforms necessary to close the 75-year fiscal gap is 50 percent larger if reforms are concentrated into the last 55 years of the 75-year period than if they are spread over the entire 75 years.

The estimates of the cost of policy delay in this Report assume policy does not affect GDP. Reducing deficits too abruptly would be counterproductive if it slows the economy's recovery. In the near term, it is crucial to strike the proper balance between deficit reduction and economic growth.

## The Primary Deficit, Interest, and Debt




The primary deficit - the difference between non-interest spending and receipts – is the only determinant of the ratio of debt to GDP that the Government controls directly. (The other determinants are interest rates and growth in GDP). Chart H shows receipts, non-interest spending, and the difference – the primary deficit – expressed as a share of GDP. The primary deficit-to-GDP ratio grew rapidly in 2008 and 2009 due to the financial crisis and the recession, and the policies pursued to combat both, and is projected to fall rapidly to near zero as the economy recovers. After 2020, the primary deficit-to-GDP ratio is projected to increase, reaching 2 percent in 2030 and remaining at or above 1.8 percent through the end of the 75-year projection period and beyond.




The revenue share of GDP fell substantially in 2009 and 2010 because of the recession and tax reductions enacted as part of the Recovery Act and is projected to return to near its long-run average as the economy recovers and the Recovery Act tax cuts expire. After the economy is fully recovered, receipts are projected to grow slightly more rapidly than GDP as increases in real incomes cause a larger share of income to fall into higher individual income tax brackets. These projections assume that Congress and the President will continue to enact legislation to prevent the share of income subject to the Alternative Minimum Tax from rising.

The projected increase in non-interest spending as a percent of GDP is principally due to growth in spending for Medicare, Medicaid, and Social Security. As shown in Chart I, the Social Security and Medicare spending shares of GDP are each projected to increase about

1-1/2 percentage points over the next 25 years as the baby boom generation retires. After 2035, the projected Social Security spending share of GDP is relatively steady, while the projected Medicare spending share of GDP continues to increase, albeit at a slower rate, due to projected increases in health care costs. The Medicaid spending share of GDP is also projected to rise over time for the same reasons.

The primary deficit projections in Chart H, along with those for interest rates and GDP, determine the projections for the ratio of debt to GDP that are shown in Chart J. That ratio was 62 percent at the end of fiscal year 2010 and under current policy is projected to exceed 70 percent in 2020, 130 percent in 2040, and 350 percent in 2085. Continued aging of the population due to increasing longevity will place upward pressure on the debt-to-GDP ratio beyond 75 years if there is no change in policy.

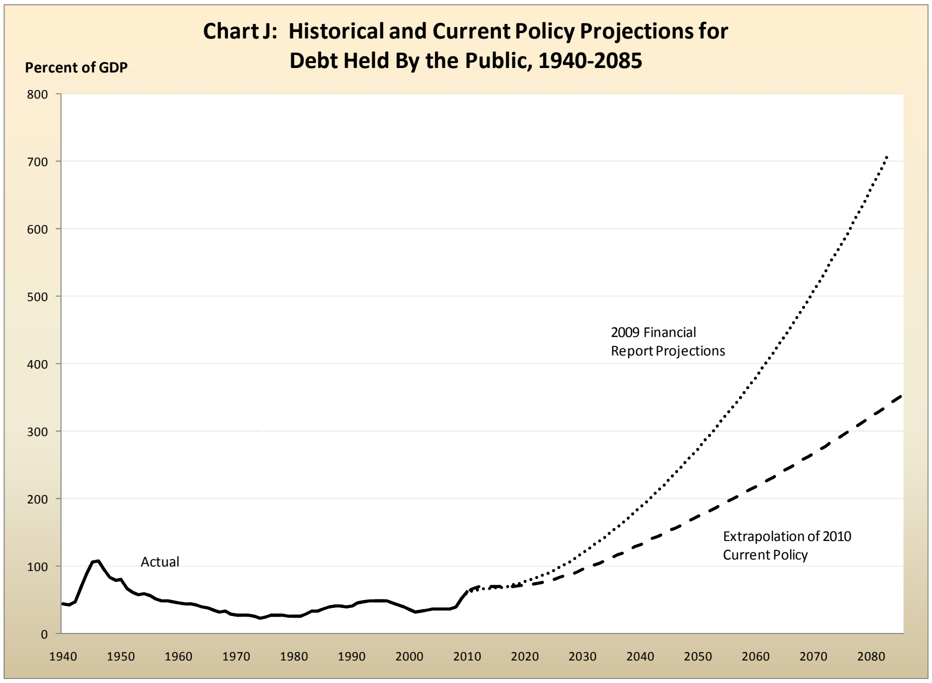
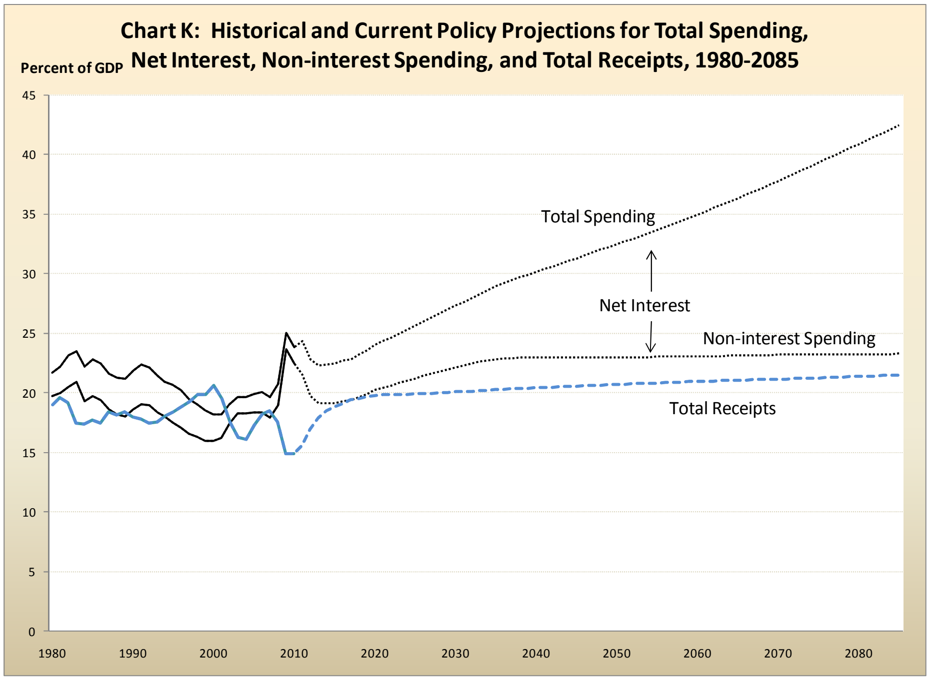



Chart J also shows the 2009 Financial Report projection of the debt to GDP ratio. The 2010 projection is lower than the 2009 projection in every year of the projection period almost entirely as a result of the Affordable Care Act (ACA), which is projected to significantly lower Medicare spending and raise receipts. Further, as discussed in Note 26, there is uncertainty about whether the projected reductions in health care cost growth will be fully achieved. Note 26 includes an alternative projection to illustrate the uncertainty of projected Medicare costs.




The change in debt held by the public from one year to the next is essentially equal to the unified budget deficit, the difference between total spending (which consists of non-interest spending plus interest spending) and total receipts. Chart K shows that the rapid rise in total spending and the unified deficit is almost entirely due to projected interest payments on the debt. Interest spending was 1.4 percent of GDP in 2010 and under current policies is projected to reach 5 percent in 2030 and 19 percent in 2085.

## The Fiscal Gap and the Cost of Delaying Policy Reform

It is estimated that preventing the debt-to-GDP ratio from rising over the next 75 years would require running primary surpluses over the period that average 0.5 percent of GDP. This compares with an average primary deficit of 1.9 percent of GDP under current policy. The difference, the "75-year fiscal gap," is 2.4 percent of GDP.

Table 7 illustrates the cost of delaying policy to close the fiscal gap by comparing three policies closing the fiscal gap that begin on different dates. The first policy begins immediately; it increases the primary surplus by 2.4 percent of GDP in every year between 2011 and 2085. This is accomplished by invoking some combination of spending reductions and revenue increases that amounts to an average of 2.4 percent of GDP in every year. The second policy shown in Table 7 begins in 2021. Because debt grows unabated between 2010 and 2020 and the same fiscal consolidation must be squeezed into ten fewer years, the primary surplus must increase by 2.9 percent of GDP in every year between 2021 and 2085 in order to close the 75-year fiscal gap. Similarly, beginning the policy change in 2031 requires that the primary surplus increase by 3.7 percent of GDP in every year between 2031 and 2085 in order to close the 75-year fiscal gap. The difference between the primary surplus boost starting in 2021 and 2031 (2.9 and 3.7 percent of GDP, respectively) and the primary surplus boost starting in 2011 (2.4 percent of GDP) is a measure of the additional burden policy delay would impose on future generations. Future generations are harmed by policy delay because the higher is the primary surplus during their lifetimes the greater is the difference between the taxes they pay and the programmatic spending they benefit from.

**Table 7: Costs of Delaying Fiscal Consolidation**

| Period of Delay | Change in Average Primary Surplus |
|---|---|
| No Delay: Reform in 2011 | 2.4 percent of GDP between 2011 and 2085 |
| Ten Years: Reform in 2021 | 2.9 percent of GDP between 2021 and 2085 |
| Thirty Years: Reform in 2031 | 3.7 percent of GDP between 2031 and 2085 |

## Conclusion

The United States took a potentially significant step towards fiscal sustainability in 2010 by enacting the ACA. The legislated changes for Medicare, Medicaid, and other parts of the health care system hold the prospect of lowering the long-term growth trend for health care costs and significantly reducing the long-term fiscal gap. But even with the new law, the debt-to-GDP ratio is projected to increase continually over the next 75 years and beyond if current policies are kept in place, which means current policies are not sustainable. Subject to the important caveat that policy changes are not so abrupt that they slow the economy's recovery, the sooner policies are put in place to avert these trends, the smaller are the revenue increases and/or spending decreases necessary to return the Nation to a sustainable fiscal path.

While this Report's projections of expenditures and receipts under current policies are highly uncertain, there is little question that current policies cannot be sustained indefinitely.

These and other issues concerning fiscal sustainability are discussed in further detail in the Supplemental Information section of this Report.

## 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 8 summarizes amounts reported in the SOSI. From Table 8, net social insurance expenditures are projected to be approximately $31 trillion as of January 1, 2010 for the "Open Group", a decline from net expenditures of $46 trillion projected in the 2009 Report.[15] Much of this decrease is attributable to estimated effects of the ACA on the Medicare program. As discussed in Note 26, there is uncertainty about whether the projected reductions in health care cost growth will be fully achieved. 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.

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 retirement of the "baby boom generation" and increases in health care costs are still anticipated to have a prolonged impact on the long-run financial condition of Medicare and Social Security, which is analyzed annually in the Medicare and Social Security Trustees' Reports. According to the Medicare Trustees' Report, the projected Medicare costs have decreased from last year's projection because of program changes made in the ACA. Under current law, including the assumption of the full implementation of ACA program changes, spending on Medicare is projected to rise from its pre-recession level of 3.2 percent of GDP to 5.5 percent in 2035 and 6.4 percent in 2084. The Hospital Insurance (HI) Trust Fund is now expected to remain solvent until 2029, 12 years longer than was projected in the prior year, after which point tax income is estimated to be sufficient to pay 85 percent of benefits, declining to 77 percent in 2050 and then increasing to 89 percent by 2084.

**Table 8: Social Insurance Future Expenditures in Excess of Future Revenues**

| Dollars in Billions | 2010 | 2009 | Increase / (Decrease) $ | % |
|---|---|---|---|---|
| Open Group (Net): | | | | |
| Social Security (OASDI) | $ (7,947) | $ (7,677) | $ 270 | 4% |
| Medicare (Parts A, B, & D) | $ (22,813) | $ (38,107) | $ (15,294) | -40% |
| Other | $ (97) | $ (94) | $ 3 | 3% |
| **Total Social Insurance Expenditures, Net (Open Group)** | **$ (30,857)** | **$ (45,878)** | $ (15,021) | -33% |
| **Total Social Insurance Expenditures, Net (Closed Group)** | **$ (43,057)** | **$ (52,145)** | $ (9,088) | -17% |
| **Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)*** | | | | |
| **Open Group** | **2010** | **2009** | | |
| Social Security (OASDI) | -0.9% | -1.0% | | |
| Medicare (Parts A, B, & D) | -2.7% | -4.8% | | |
| Other | 0.0% | 0.0% | | |
| **Total (Open Group)** | **-3.7%** | **-5.8%** | | |
| **Total (Closed Group)** | **-5.1%** | **-6.6%** | | |

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.

* GDP values from the 2010 & 2009 Social Security and Medicare Trustees Reports represent the present value of GDP over the 75 years. As the GDP used for Social Security and Medicare differ slightly in the Trust Fund Reports, the two values are averaged to estimate the Total Net Expenditures as % of GDP.

As for Social Security (the Old Age Survivors and Disability Insurance Trust Funds or OASDI), combined spending is projected to rise from 4.8 percent of GDP in 2009 to 6.1 percent in 2035, before retreating to 5.9 percent in 2050. The Social Security Trustees' Report indicates that annual OASDI income, including interest on trust fund assets, will exceed annual cost and trust fund assets will increase every year until 2025, at which time it will be necessary to begin drawing down on trust fund assets to cover part of expenditures until assets are exhausted in 2037. After trust fund exhaustion, continuing tax income would be sufficient to pay 78 percent of scheduled benefits in 2037 and 75 percent in 2084.[16] 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 (as was previously discussed). Additional information from the Trustees Reports may be found in the Supplemental Information section of this Report.

[15] '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.

[16] A Summary of the 2010 Annual Social Security and Medicare Trust Fund Reports, pp. 10-11.

As indicated earlier, GAO disclaimed an opinion on the 2010 SOSI, because of significant uncertainties (discussed in note 26), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2010 SOSI.

# Systems, Controls, and 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) in FY 2010 remains at 17, and the number of auditors reporting compliance with FFMIA remains at 14 (see Appendix F). The annual compliances reported each year underscores the importance of current initiatives to standardize the financial management practices across the Federal Government.

## Controls

Federal managers have a fundamental responsibility to develop and maintain effective internal control. Effective internal controls help 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 (c), (d) (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 2010 agency financial statement audit results, the total number of material weaknesses decreased from 38 to 31 and the total number of repeat material weaknesses decreased from 29 to 26. Improvements were made in the controls over the financial statement preparation process, Property, Plant, and Equipment reporting, and liability reporting. Effective internal controls are a challenge not only at the agency level, but also at the governmentwide 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.

# 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 governmentwide financial management priorities. As required in the Chief Financial Officers (CFO) 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.[17] 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 CFO 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 2010. In addition, the number of auditor-identified material weaknesses stands at 31, a more than 50 percent decline from the 61 material weaknesses that were identified at the start of this past decade.

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.

## 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 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 reported approximately $125 billion in improper payments in FY 2010 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.

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[17] 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.

- **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 where cost-effective.
- **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. Addressing improper payments is a central component of Administration efforts to eliminate waste. Over the past year, the President has issued Executive Order 13520 on Reducing Improper Payments, a Presidential memorandum on intensifying and expanding agency efforts to recapture improper payments, and a Presidential memorandum directing that a Do Not Pay List be established to help prevent improper payments from being made to ineligible recipients. In addition, the President also signed into law the Improper Payments Elimination and Recovery Act, which amends IPIA. While agencies are currently implementing these initiatives, we are starting to see early results. Based on information submitted by agencies in their FY 2010 Performance and Accountability Reports, the Government-wide error rate is 5.49 percent, a decrease from the FY 2009 rate of 5.65 percent or $3.8 billion less in estimated improper payments. In addition, agencies recaptured $687 million in improper payments to contractors and vendors in FY 2010, an approximately 300 percent increase from FY 2009. More information on agency improper payments and the Administration's improper payment initiatives can be found at PaymentAccuracy.gov.
- *Accelerating Efforts to Better Manage Federal Real Property.* The Administration is focused on improving the management of real property assets. It supports 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. On June 10, 2010, the President signed a memorandum on *Disposing of Unneeded Federal Real Estate—Increasing Sales Proceeds, Cutting Operating Costs, and Improving Energy Efficiency*, which directed Federal agencies to accelerate efforts to remove excess and surplus property. This effort is expected to produce billions of dollars in cost savings through reducing annual operating costs, reducing square footage through space realignment efforts such as consolidating existing space within owned buildings and reflecting the impact of telework on properties, as well as through the proceeds retained through the sale of a building. To date, Federal agencies have identified $1.7 billion of the $3 billion in non-defense savings opportunities that the President has required agencies to achieve by the end of FY 2012.
- *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 $275 billion in grants to recipients through new ARRA programs and existing programs. In 2009, OFFM initiated and completed a pilot project for early review of and reporting on internal controls for major ARRA programs using the Single Audit process, as required under OMB Circular A-133. In 2010, OFFM continues the Phase 2 of the project for fiscal year 2010 single audits. OMB also requires the agencies to review the audit findings and highlight the high risk areas along agency corrective action plans. 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. OFFM 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. In June, OMB froze activity on agency financial system plans pending their immediate review and approval. To date, a total of 20 agencies have reviewed and aligned their financial system plans through splitting projects into smaller, simpler segments with clear deliverables; focusing on the most critical business needs first; and ensuring ongoing, transparent project oversight. As a result, agencies are more focused on their core business priorities while still being held accountable for demonstrating results. Not only have these reviews helped to change how government does business, they have also helped to reduce budget costs. In addition, several high-risk projects were identified during the reviews, which will be under close scrutiny and subject to intense oversight to include continued review by OMB, in consultation with the Financial Systems Advisory Board. Additional next steps include the establishment of Customer Control Boards that will help to organize agencies that are leveraging similar solutions. This will allow the agencies to pool resources, share strategies, and organize solutions across the Government in an effort to support the combined interests of agencies to modernize at a pace and scope that fits their individual business needs.

- *Implementing Common Solutions for Financial Management Functions:* Existing and new capabilities are being evaluated 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. The Treasury Department will identify and pilot potential solutions to capture vendor invoices. In addition, Treasury is also working aggressively to identify electronic solutions to assist with intragovernmental transactions.

### Promoting Accountability and Innovation through Open Government

- *Improving Data Quality for Federal Spending Information.* Ensuring the quality of Federal spending information has been central to OMB's efforts in implementing the Federal Funding Accountability and Transparency Act. In December 2009, the Administration established the Open Government Directive (M-10-06), which required each agency take specific steps to ensure that data is reported quickly, efficiently, and accurately. The Directive further required agencies to designate a senior official to be accountable for the quality, objectivity of, and internal controls over, Federal spending information publicly disseminated through USAspending.gov. The Open Government Directive was quickly followed by the Data Quality Framework in February, which provides specific guidance on data quality plans as they relate to Federal spending data. Pursuant to this guidance, Federal agencies developed these specific data quality plans that outline a governance structure, risk assessment process, governing principles and controls, communications, and monitoring of Federal spending information. 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. In April and August 2010, OMB issued guidance to Federal agencies on improving information quality and required the reporting of grants and contracts sub-award information. Both prime Federal contractors and prime Federal grant recipients are required to report sub-award information, for display into USAspending.gov. Access to both prime and now sub-award data offers the public with unprecedented amounts of information on Federal spending. This increased transparency will ensure that the Federal Government is held fully accountable for the administration of Federal programs. Notwithstanding these accomplishments, efforts must continue to address existing and burgeoning data quality concerns. Informed by stakeholder input and recommendations, OMB and Federal agencies will work to ensure that high quality Federal spending information is available to promote accountability and ultimately be used to improve the performance of our Federal programs.
- *Partnering For Solutions*. The Partnership Fund for Program Integrity Innovation (Partnership Fund) was established by the Consolidated Appropriations Act of 2010 (P.L. 111-117) to fund pilot projects to improve delivery of Federal assistance programs administered through state and local governments or where Federal-state cooperation could be beneficial. Funding supports pilots and evaluations of promising innovations that confront these challenges in Federal, state and/or local administration. Partnership Fund pilots advance four goals:
  - improve payment accuracy;
  - improve administrative efficiency;
  - improve service delivery;
  - reduce access barriers for eligible beneficiaries.

  OMB is actively working with a Collaborative Forum of federal agencies, state and local administrators, industry and other stakeholders to identify pilot opportunities that could inform the expansion of innovations to other state or local agencies as well as further potential administrative or legislative action to facilitate these goals. In aggregate, pilots must save at least as much as they cost.

- *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, developed a new statement of spending that focused on how and where Federal money was spent. This new statement will be piloted in FY 2011and will establish reliable reporting of how taxpayer dollars are being spent.

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 Financial Management Community has made critical progress- decreasing the Government-wide Improper Payment rate resulting in $3.8 billion less in estimated improper payments, increasing the amount of recaptured improper payments by approximately 300 percent, and identifying $1.7 billion in non-defense saving opportunities with real property. 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 http://www.gao.gov/financial.html, 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.