MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The fiscal year (FY) *2011 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 emphasizes 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 government-wide 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 fourteen years, a "disclaimer" of opinion on the accrual-based consolidated financial statements for the fiscal years ended September 30, 2011 and 2010. Additionally, GAO issued disclaimers of opinion on the 2011 and 2010 Statements of Social Insurance (SOSI), following unqualified opinions on the 2007, 2008, and 2009 SOSI, and a disclaimer of opinion on the 2011 Statement of Changes in Social Insurance Amounts (SCSIA). A disclaimer of opinion indicates that sufficient information was not available for the auditors to determine whether the reported financial statements were fairly presented. In FY 2011, 32[1] of the 35 most significant agencies earned unqualified opinions on their financial statement audits.[2]

The FY 2011 *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, including a new Statement of Changes in Social Insurance Amounts;
- 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

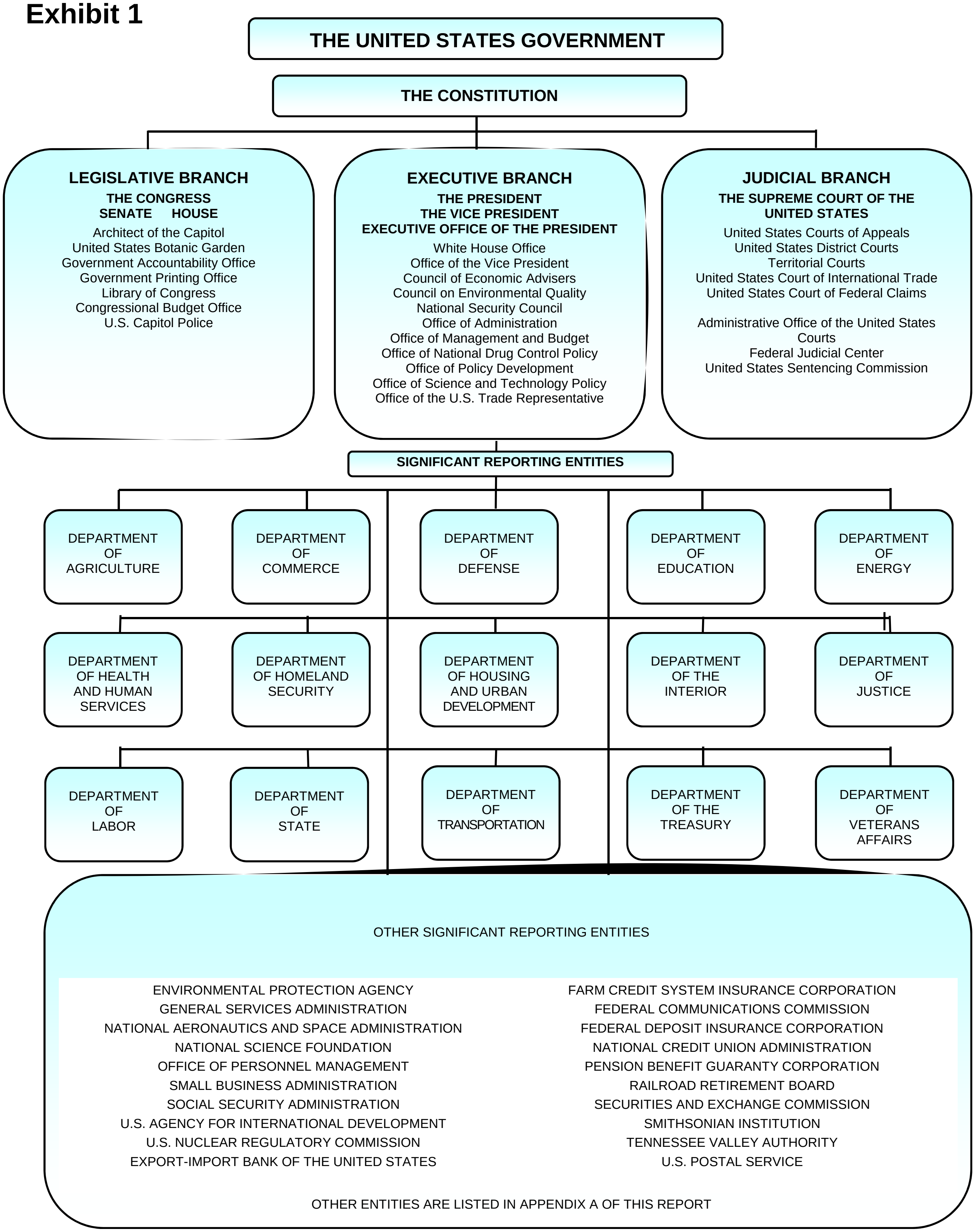
The Government's fundamental mission is derived from the Constitution*: **"…to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity."*** The Congress authorizes 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.

[1] The Department of Health and Human Services received a disclaimer of opinion on its 2011 SOSI and SCSIA.

[2] 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 2011 audits are not yet complete. Statistic reflects 2010 audit results for these organizations.

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

Exhibit 1



The Government's Financial Position and Condition

A complete assessment of the Government's financial or fiscal condition requires analysis of historical results, projections of future revenues and expenditures, and an assessment of the Government's long-term fiscal sustainability. This Report discusses the Government's financial position at the end of the fiscal year, explains how and why the financial position changed during the year, and provides insight into how the Government's financial condition may change in the future.

Table 1
The Federal Government's Financial Position and Condition

Dollars in Billions	2011	2010	Increase / (Decrease) $	Increase / (Decrease) %
FINANCIAL MEASURES				
Gross Cost	$ (3,998.3)	$ (4,472.3)	**$ (474.0)**	**(10.6%)**
Less: Earned Revenue	$ 365.6	$ 309.2	$ 56.4	18.2%
Gain/(Loss) from Changes in Assumptions	$ (28.1)	$ (132.9)	$ (104.8)	(78.9%)
Net Cost[1]	**$ (3,660.8)**	**$ (4,296.0)**	**$ (635.2)**	**(14.8%)**
Less: Taxes and Other Revenue:	$ 2,363.8	$ 2,216.5	$ 147.3	6.6%
Unmatched Transactions & Balances	$ (15.6)	$ (0.8)	$ 14.8	1850.0%
Net Operating Cost[2]	**$ (1,312.6)**	**$ (2,080.3)**	**$ (767.7)**	**(36.9%)**
Assets[3]:				
Cash & Other Monetary Assets	$ 177.0	$ 428.6	$ (251.6)	(58.7%)
Loans Receivable and Investments, Net[4]	$ 985.2	$ 942.5	$ 42.7	4.5%
Property, Plant & Equipment, Net	$ 852.8	$ 828.9	$ 23.9	2.9%
Other	$ 692.3	$ 683.8	$ 8.5	1.2%
Total Assets	**$ 2,707.3**	**$ 2,883.8**	**$ (176.5)**	**(6.1%)**
Liabilities[3]:				
Federal Debt Held by the Public & Accrued Interest	$ (10,174.1)	$ (9,060.0)	$ 1,114.1	12.3%
Federal Employee & Veterans Benefits	$ (5,792.2)	$ (5,720.3)	$ 71.9	1.3%
Other	$ (1,526.4)	$ (1,576.3)	$ (49.9)	(3.2%)
Total Liabilities	**$ (17,492.7)**	**$ (16,356.6)**	**$ 1,136.1**	**6.9%**
Net Position (Assets minus Liabilities)	**$ (14,785.4)**	**$ (13,472.8)**	**$ (1,312.6)**	**(9.7%)**
SUSTAINABILITY MEASURES				
Social Insurance Net Expenditures[5]:				
Social Security (OASDI)	$ (9,157)	$ (7,947)	$ 1,210	15.2%
Medicare (Parts A, B, & D)	$ (24,572)	$ (22,813)	$ 1,759	7.7%
Other	$ (101)	$ (97)	$ 4	4.1%
Total Social Insurance Net Expenditures	**$ (33,830)**	**$ (30,857)**	**$ 2,974**	**9.6%**
Total Federal Government Noninterest Net Expenditures[6]	**$ (6,400)**	**$ (16,300)**	**$ (9,900)**	**(60.7%)**
BUDGET DEFICIT				
Unified Budget Deficit[7]	**$ (1,298.6)**	**$ (1,294.1)**	**$ 4.5**	**0.3%**

1 Source: Statement of Net Cost.

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 Represents the 75-year projection of the Federal Government's receipts less non-interest spending as reported in the Statement of Long-Term Fiscal Projections in the Supplemental Information section of the Financial Report.

7 Source: Final Monthly Treasury Statement (as of 9/30/2011 and 9/30/2010).

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

Table 1 on the previous page and the following summarize the Federal Government's financial position:

- The Government's gross costs decreased nearly 11 percent to $4.0 trillion. Deducting $365.6 billion in revenues earned for services provided (e.g., national park fees) and adding $28.1 billion in losses from changes in assumptions yields a net cost of $3.7 trillion.
- Taxes and other revenues increased $147 billion to $2.4 trillion, which, when offset against the Government's net cost, results in a "bottom line" net operating cost of $1.3 trillion.
- Comparing total 2011 Government assets of $2.7 trillion to total liabilities of $17.5 trillion yields a negative net position of $14.8 trillion. Government liabilities are comprised mostly of $10.2 trillion in Federal debt held by the public and accrued interest payable[3] and $5.8 trillion of Federal employee and veterans benefits payable.
- As of September 30, 2011, the Government's total debt subject to the debt limit was $14.747 trillion. Pursuant to the Budget Control Act of 2011 (BCA), the debt limit was increased by a combined $900 billion to $15.194 trillion during FY 2011.

This Report also contains information about potential impacts on the Government's future financial condition. Under Federal accounting rules, social insurance expenditures, as reported in the Statement of Social Insurance (SOSI) and the Statement of Long-Term Fiscal Projections (included in the Supplemental Information section of the Report) are not considered liabilities of the Federal Government. They can, however, provide a valuable perspective on the sustainability of the Government's fiscal path:

- The SOSI compares the actuarial present value of the Government's projected expenditures for scheduled benefits for Social Security, Medicare Parts A, B and D, and other social insurance programs over 75 years[4] to a subset of the revenues[5] supporting these programs. In the 2011 SOSI, projected social insurance expenditures exceeded projected revenues by $34 trillion, a $3 trillion increase over 2010 projections.
- From a government-wide perspective, projected expenditures for other major programs (including defense, Medicaid, and education) and future tax revenues will also affect the Government's future fiscal condition. Over the next 75 years, under current policy, the Government's total projected, non-interest expenditures (including its social insurance programs) are projected to exceed total projected receipts by $6.4 trillion.

The Government's current financial position and long-term financial condition can be evaluated 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 is a useful indicator of the economy's capacity to sustain the Government's many programs. For example:

- Outlays of $3.6 trillion net of receipts of $2.3 trillion yielded a FY 2011 unified budget deficit that remained essentially flat compared to FY 2010 at $1.3 trillion (8.7 percent of GDP).[6]
- 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 2011, debt held by the public, excluding interest payable, of $10.1 trillion, equates to 67.7 percent of GDP.
- The projected $34 trillion excess of expenditures over receipts over 75 years for the programs reported in the 2011 SOSI represents about 3.8 percent of the present value of GDP over 75 years. The excess of total projected non-interest spending over receipts of $6.4 trillion discussed in the 'Statement of Long Term Fiscal Projections' in the Supplemental Information section of the Report represents 0.7 percent of GDP. As discussed in this report, these projections can, in turn, have a significant impact on projected debt as a percent of GDP.

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[3] On the Government's balance sheet, debt held by the public and accrued interest payable consists of Treasury securities, net of unamortized discounts and premiums, and accrued interest payable. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Federal Government.

[4] The Black Lung Program is projected through September 30, 2040.

[5] Social Security and Medicare Part A are funded by the payroll taxes and revenue from taxation of benefits and premiums that support those programs. Medicare Parts B and D are primarily financed by general revenues. By accounting convention, general revenues are eliminated in consolidation at the government-wide level and, as such, are not included in SOSI projections.

[6] Final Monthly Treasury Statement (as of September 30, 2011 and 2010).

Fiscal Year 2011 Financial Statement Audit Results

For FY 2011, the Government Accountability Office (GAO) issued a fifteenth consecutive disclaimer of audit opinion on the accrual-based government-wide financial statements. In addition, GAO issued disclaimers of opinion on the 2011 and 2010 audits of the Statements of Social Insurance (SOSI), following unqualified SOSI opinions on the 2009, 2008, and 2007 SOSI, and a disclaimer of opinion on the 2011 Statement of Changes in Social Insurance Amounts (SCSIA). The 2011 and 2010 SOSI and 2011 SCSIA disclaimers stem from significant uncertainties (discussed in note 26), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2011 and 2010 SOSI.

Twenty-one of the 24 agencies required to issue audited financial statements under the Chief Financial Officers (CFO) Act received unqualified audit opinions, as did 11 of 11 additional significant reporting agencies, (see Table 2 and Appendix A for a list of these agencies)[7].

Table 2: FY 2011 Financial Statement Audit Results by Agency

Chief Financial Officers (CFO) Act Agency	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)[1]	Unqualified
Department of Homeland Security (DHS)[2]	Qualified
Department of Housing and Urban Development (HUD)	Unqualified
Department of the Interior (DOI)	Unqualified
Department of Labor (DOL)	Unqualified
Department of Justice (DOJ)	Unqualified
Department of State (State)[3]	Qualified
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)	Unqualified
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
Other Significant Reporting Entities	**Audit Opinion**
Export-Import Bank of the United States	Unqualified
Farm Credit System Insurance Corportation (FCSIC)[4]	Unqualified
Federal Communications Commission (FCC)	Unqualified
Federal Deposit Insurance Corporation (FDIC)[4]	Unqualified
National Credit Union Administration (NCUA)[4]	Unqualified
Pension Benefit Guaranty Corporation (PBGC)	Unqualified
Railroad Retirement Board (RRB)	Unqualified
Securities and Exchange Commission (SEC)	Unqualified
Smithsonian Institution[5]	Unqualified
Tennessee Valley Authority (TVA)	Unqualified
U.S. Postal Service (USPS)	Unqualified

[1] Recieved disclaimer of opinion on Statement of Social Insurance and Statement of Changes in Social Insurance Amounts.

[2] Balance Sheet and Custodial Statement Audit Only.

[3] Received unqualified opinion on Statement of Budgetary Resources and Consolidated Statement of Net Cost, and a qualfied opinion on the Consolidated Balance Sheet and Statement of Changes in Net Position.

[4] Entities operate under calendar year (CY)-end. Opinions reflect CY 2010 audit results.

[5] Opinion on the most recent annual report, covering FY 2010.

The Government-wide 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 certain 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 Emergency Economic Stabilization Act (EESA) of 2008 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 (U.S. 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

[7] The Department of Health and Human Services received a disclaimer of opinions on its 2011 SOSI and SCSIA.

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 the financial results of such entities 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. Appendix A includes a list of the agencies and entities contributing to this report.[8]

The following pages contain a more detailed discussion of the Government's financial results for FY 2011, 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 to the Nation's leaders for managing current operations and planning future initiatives.

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 and changes in 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 President's Budget and The Financial Report

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

Treasury generally prepares the financial statements in this Report on an "accrual basis" of accounting as prescribed by U.S. GAAP for Federal entities.[9] 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 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*" • Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them. • Receipts ("cash in"), taxes and other collections recorded when received. • Outlays ("cash out"), largely recorded when payment is made.	Prepared on an "*accrual and modified cash basis*" • Agency-based and retrospective – prior and present resources used to implement initiatives. • Revenue: Tax revenue (more than 90 percent of total revenue) recognized on modified cash basis (see Financial Statement Note 1.B). Remainder recognized when earned, but not necessarily received. • Costs: recognized when owed, but not necessarily paid.

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

[8] Since programs are not administered at the government-wide 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.

[9] Under U.S. 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 September 30, 2040 for the Black Lung program.

Budget Deficit vs. Net Operating Cost

As the economy continues along a path of gradual recovery, the Government's primarily cash-based[10] budget deficit remained relatively flat at about $1.3 trillion, compared to FY 2010, following significant increases during FY 2008 and especially FY 2009 due to the impacts of the financial crisis, the recession, and the policy actions responding to both. These increases were 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 increase in recent years. However, the deficit decreased during FY 2010 and remained largely unchanged in 2011.

The Government's largely accrual-based net operating cost (which decreased from a record high of nearly $2.1 trillion in FY 2010 to $1.3 trillion in FY 2011) typically exceeds the deficit due largely to the inclusion of cost accruals or changes in future estimated liabilities for the Government's postemployment benefit programs for its military and civilian employees, as well as its veterans. 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 are not included in the largely cash-based budget deficit. Agencies and their actuaries estimate the liability for these benefits over the long-term, but funds have yet to actually be spent. Similarly, changes in estimated long-term liabilities associated with economic recovery programs supporting Fannie Mae and Freddie Mac also result in costs that are reflected in the Government's financial statements, but not in the Budget.

Table 3 shows that, for FY 2011, the $14 billion net difference between the Government's budget deficit and net operating cost is minimal, especially when compared to FY 2010 net difference of $786.2 billion. As indicated in Table 3, this is largely due to agencies recording large increases in liabilities for employee and veterans benefits, and support for Government-Sponsored Enterprises (GSEs) – Fannie Mae and Freddie Mac in FY 2010 ($503.1 billion and $268 billion, respectively) and significantly smaller changes for these same amounts in FY 2011 ($71.9 billion increase and $43.7 billion decrease, respectively). As discussed in greater detail later, the smaller estimates of the increase in future employee and veterans benefits relative to FY 2010 stems from changes in experience and economic and demographic assumptions, as well as the implementation of a new Federal accounting standard during FY 2010 that provided for greater consistency in these estimates. GSE estimated liabilities decreased due to payments to the GSEs and lower loss projections. As discussed later and as indicated in the "change" column of Table 3, the difference in the changes of these estimates resulted in significant actuarial and total cost reductions for the Federal Government during FY 2011.

Table 3: Budget Deficit vs. Net Operating Cost

Dollars in Billions	2011	2010	Increase / (Decrease)
Net Operating Cost	**$ (1,312.6)**	**$ (2,080.3)**	**$ (767.7)**
Change in:			
Federal Employee and Veterans Benefits Payable	$ 71.9	$ 503.1	$ (431.2)
Liabilities for Government Sponsored Enterprises	$ (43.7)	$ 268.0	$ (311.7)
Other, Net	$ (14.2)	$ 15.1	$ (29.3)
Subtotal - Net Difference:	$ 14.0	$ 786.2	$ (772.2)
Budget Deficit	**$ (1,298.6)**	**$ (1,294.1)**	**$ 4.5**

[10] 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 the 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, (the difference between its assets and liabilities), and its "bottom line" net operating cost (the difference between its revenues and costs) are also key financial indicators.

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.

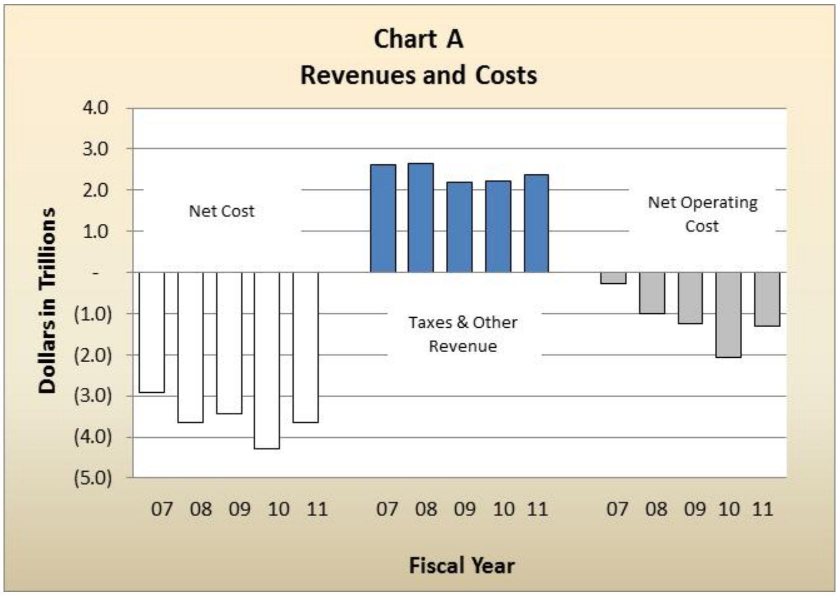


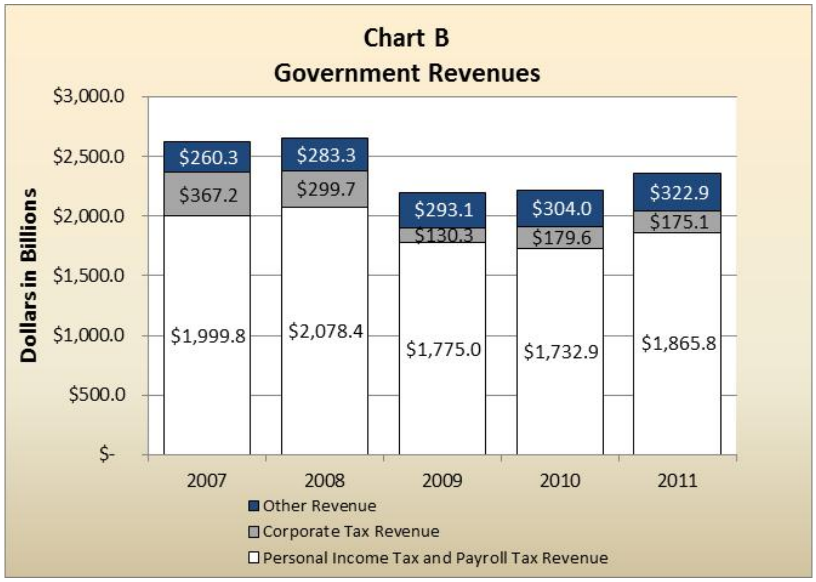
Chart A and Table 4 show that the Government has incurred a total net operating cost (i.e., costs have exceeded its revenues) over the past several years, causing net position to decline. In summary, Table 4 shows that during FY 2011, the Government's "bottom line" net operating cost of $1,312.6 billion decreased by 37 percent or $768 billion, compared to 2010's net operating cost of $2,080.3 billion. As summarized in Table 4 and as will be discussed below, the net decrease in net operating cost in FY 2011 was caused by both a slight revenue increase and a significant net cost decrease.

Table 4: Gross Cost, Revenues, and Net Cost

Dollars in Billions		2011		2010	Increase / (Decrease) $	%
Gross Cost	**$**	**(3,998.3)**	**$**	**(4,472.3)**	**$ (474.0)**	**(10.6%)**
Less: Earned Revenue	$	365.6	$	309.2	$ 56.4	18.2%
Subtotal	**$**	**(3,632.7)**	**$**	**(4,163.1)**	**$ (530.4)**	**(12.7%)**
Gain/(Loss) from Changes in Assumptions	$	(28.1)	$	(132.9)	$ (104.8)	78.9%
Net Cost	**$**	**(3,660.8)**	**$**	**(4,296.0)**	**$ (635.2)**	**(14.8%)**
Less: Taxes and Other Revenue	$	2,363.8	$	2,216.5	$ 147.3	6.6%
Unmatched Transactions and Balances	$	(15.6)	$	(0.8)	$ 14.8	1850.0%
Net Operating Cost	**$**	**(1,312.6)**	**$**	**(2,080.3)**	**$ (767.7)**	**(36.9%)**

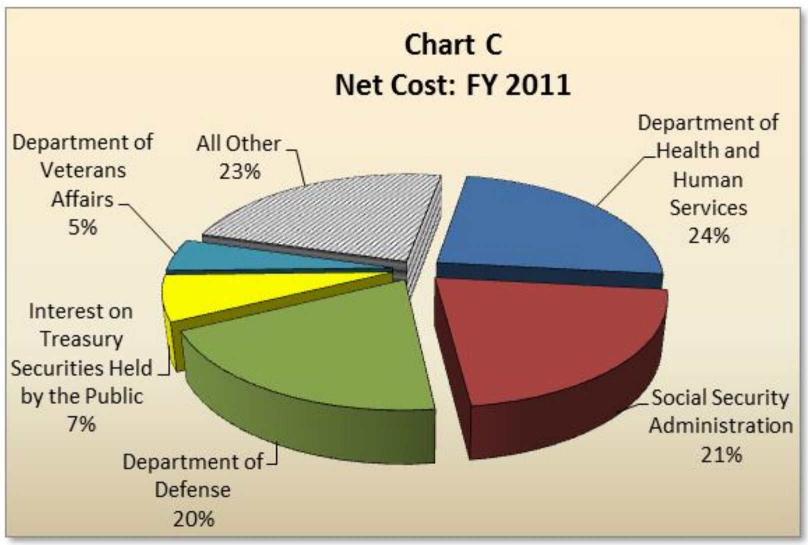
The ***Reconciliation of Net Operating Cost and Unified Budget Deficit Statement*** shows how the Government's net operating cost from the primarily accrual-based financial statements relates to the more widely-known and primarily cash-based budget deficit. As summarized in Table 3 on the previous page, most of this difference is attributable to cost related to changes in the estimated present value of the Federal Government's net liabilities for Federal Employee and Veterans' Benefits. The impact of these accrual costs on the Government's total net costs is shown in Chart E.

Revenue: "What Came In"



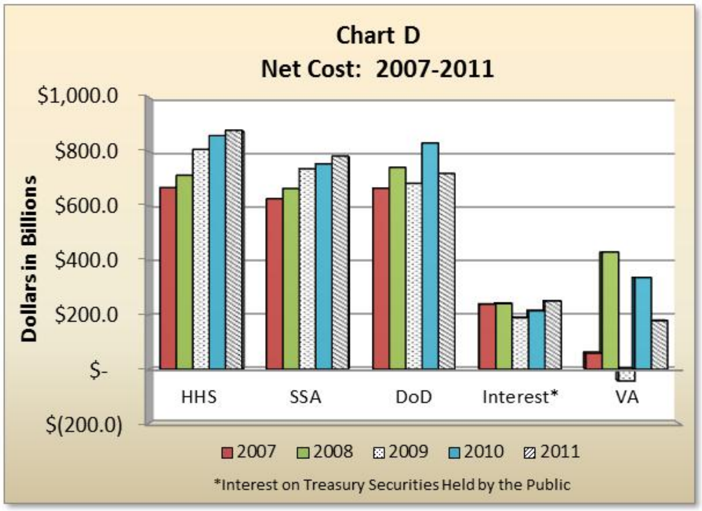
The ***Statement of Net Cost*** reports "earned" revenue generated by Federal programs, including Medicare premiums paid by program participants and postal service fees. The ***Statement of Operations and Changes in Net Position*** shows the Government's taxes and other revenues (i.e., revenues other than "earned"). As shown in Chart B, a slight increase in personal income tax and other revenues, partially offset by a slight decrease in corporate tax revenues combined to increase total Government revenues by $147 billion (6.6 percent) to about $2.4 trillion for FY 2011. Together, personal and corporate income taxes accounted for 86 percent of total revenues in FY 2011. The remaining 14 percent consists of various other taxes and receipts, including excise taxes, unemployment taxes, and customs duties.

Cost: "What Went Out"

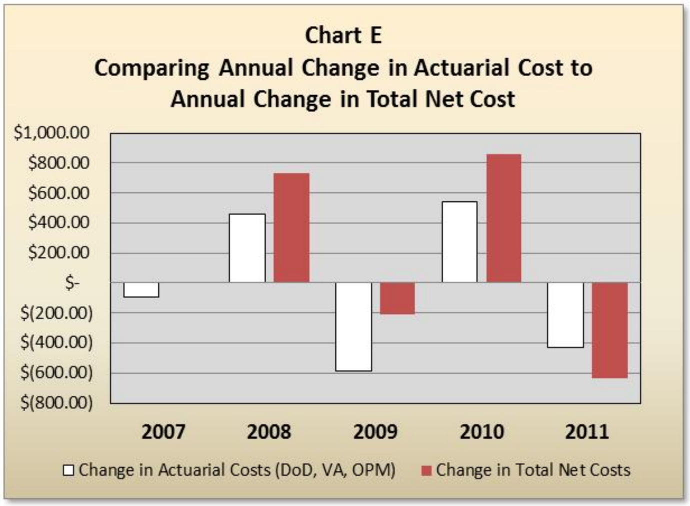


The ***Statement of Net Cost*** also shows how much it costs to operate the Federal Government, recognizing expenses when they happen, regardless of when payment is made (accrual basis). It shows the derivation of the Government's <u>net cost</u> or the net of: (1) the costs of goods produced and services rendered by the Government, (2) the earned revenues generated by those goods and services during the fiscal year, and (3) gains or losses from changes in assumptions impacting longer-term estimated costs. 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 <u>*net operating cost*</u>. Chart C shows the composition of the Government's net cost (gross cost less earned revenue and gain/loss from changes in assumptions) of $3,660.8 billion in FY 2011, which decreased about 15 percent or $635.2 billion compared to FY 2010. In FY 2011, about two-thirds of total net cost came from the Department of Defense (DOD), the Social Security Administration (SSA), and the Department of Health and Human Services (HHS), which have consistently incurred the largest agency shares of the Government's total net cost in recent years, as shown in Charts C and D. The bulk of HHS and SSA costs (which totaled $877.1 billion and $782.5 billion in FY 2011, respectively) 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, including the broader discussion of the Government's long-term fiscal projections, discuss the projected future revenues, expenditures, and sustainability of these programs in greater detail. DOD net costs of $718.7 billion relate primarily to operational activities and the longer-term costs of military retirement and health benefits. Charts C and D show that the Department of Veterans Affairs (VA) as well as interest on debt held by the public were also significant contributors to the Government's net cost during FY 2011. The combined other agencies included in the Government's Statement of Net Cost accounted for 23 percent of the Government's total net cost.

In recent years, the changes in the Government's net cost have been significantly impacted by changes in the current costs of and especially the actuarial and other estimated costs associated with the Government's postemployment benefits programs for its military and civilian employees reported primarily by the Office of Personnel Management (OPM), DOD, and VA:



- OPM recorded a total agency cost decrease of $126 billion due primarily to actual cost of living adjustment (COLA) and salary increases being lower than expected and actuarial estimate changes.[11]
- DOD cost decreased $131 billion due to changes in the discount rate and demographic assumptions used to calculate military retiree health benefits.[12]
- VA recorded a cost decrease of $152.7 billion in FY 2011, compared to a significant increase in FY 2010 due to the recognition of the initial cost for three new presumptive disability benefits in FY 2010 (subsequent adjustments each year are comparatively smaller) and the implementation of revised projection and calculation methods under a new Federal accounting standard.[13]



In the aggregate, the combined decrease of $431.2 billion from Table 3 in actuarial and other estimated costs associated with the change in estimated liabilities for the Government's three largest postemployment benefits programs, including veterans' benefits, accounted for more than two-thirds of the $635.2 billion total net decrease in the Government's total net cost for FY 2011 (see Chart E).

By comparison and to illustrate the volatility of the changes in these costs, during FY 2010, increases in actuarial costs of more than $538 billion accounted for 65 percent of the total $826.6 billion increase in the Government's 2010 net cost.

These agencies employ a complex series of assumptions, including but not limited to interest rates, beneficiary eligibility, life expectancy, medical cost levels, compensation levels, 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. Table 4 shows that the losses associated with these changes in assumptions totaled only $28.1 billion in FY 2011, but reflected a decrease of $105 billion compared to losses incurred in FY 2010. DOD, VA, and OPM each attributed significant decreases in their respective agency total net costs largely to changes in these assumptions.

In addition, a decline in net costs at the Department of the Treasury of $288 billion (77 percent) during FY 2011 was another significant contributor to the decline in the Government's total net costs. Last year, Treasury recorded a $268 billion increase in net cost related to the expense associated with recording a contingent liability for

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[11] OPM FY 2011 Agency Financial Report (AFR), p. 16. Cost reduction reflects amounts reported in OPM's annual AFR. Agency costs reported in their AFRs are adjusted at the government-wide level in this Report for consolidation and allocation of inter-agency costs.

[12] DOD FY 2011 AFR, p. 29. Cost reduction reflects amounts reported in DOD's annual AFR. Agency costs reported in their AFRs are adjusted at the government-wide level in this Report for consolidation and allocation of inter-agency costs.

[13] VA FY 2011 Performance and Accountability Report (PAR) p. I-95. Cost reduction reflects amounts reported in VA's PAR. Agency costs reported in their PARs are adjusted at the government-wide level for consolidation and allocation of inter-agency costs.

projected total costs payable to the Government Sponsored Enterprises (GSEs) under the Senior Preferred Stock Purchase Agreement (SPSPA) program. Payments to and revised loss projections for the GSEs resulted in a $43.7 billion reduction of the estimated liability for FY 2011, which, when compared to the $268 billion liability increase (cost) in 2010, yields a combined decrease of $311.7 billion (see Table 3).

As noted earlier, taxes and other revenues of $2,363.8 billion are deducted from the Government's total net cost of $3,660.8 billion (including actuarial costs) to derive a "bottom line" net operating cost[14]. As previously shown in Table 4, a slight increase in taxes and other revenues, combined with the nearly 15 percent decrease in net costs, resulted in a "bottom line" net operating cost of about $1.3 trillion ($1,312.6 billion) for FY 2011, a decrease of 37 percent or $767.7 billion, compared to the FY 2010 net operating cost of about $2.1 trillion ($2,080.3 billion).

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

The Federal Government's 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, when such items as the Government's future social insurance exposures (namely, Medicare and Social Security), as well as other fiscal projections, commitments and contingencies, are taken into account. These exposures are discussed later in this Management Discussion and Analysis (MD&A) section as well as in the supplemental disclosures of this Report.

Table 5: Assets and Liabilities

Net Position Dollars in Billions	2011	2010	Increase (Decrease) $	Increase (Decrease) %
Assets				
Cash & Other Monetary Assets	$ 177.0	$ 428.6	$ (251.6)	(58.7%)
Loans Receivable and Investments, Net*	$ 985.2	$ 942.5	$ 42.7	4.5%
Inventories	$ 296.1	$ 286.2	$ 9.9	3.5%
Property, Plant & Equipment, Net	$ 852.8	$ 828.9	$ 23.9	2.9%
Other	$ 396.2	$ 397.6	$ (1.4)	(0.4%)
Total Assets	**$ 2,707.3**	**$ 2,883.8**	**$ (176.5)**	**(6.1%)**
Less: Liabilities, comprised of:				
Federal Debt Held by the Public & Accrued Interest	$ (10,174.1)	$ (9,060.0)	$ 1,114.1	12.3%
Federal Employee & Veterans Benefits	$ (5,792.2)	$ (5,720.3)	$ 71.9	1.3%
Other	$ (1,526.4)	$ (1,576.3)	$ (49.9)	(3.2%)
Total Liabilities	**$ (17,492.7)**	**$ (16,356.6)**	**$ 1,136.1**	**6.9%**
Net Position (Assets Minus Liabilities)	**$ (14,785.4)**	**$ (13,472.8)**	**$ (1,312.6)**	**(9.7%)**

*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, 2011, the Government held about $2.7 trillion in assets, comprised mostly of net property, plant, and equipment ($852.8 billion in FY 2011) and a combined total of $985.2 billion in net loans receivable and mortgage-backed securities, and investments, including amounts associated with the Troubled Asset Relief Program (TARP) and the GSEs as discussed later. During FY 2011, the Government's total assets decreased by $176.5 billion, due in large part to the elimination of cash deposits with the Federal Reserve held under the Supplementary Financing Program (SFP). Under the SFP, the Treasury issued special bills, which provided cash that the Federal Reserve used to manage its authorized lending and liquidity initiatives. As of September 30, 2011, there were no outstanding cash management bills earmarked for SFP as compared to $200 billion as of September 30, 2010. In addition to assets recorded on the balance sheet, the Government discloses that it also owns certain other

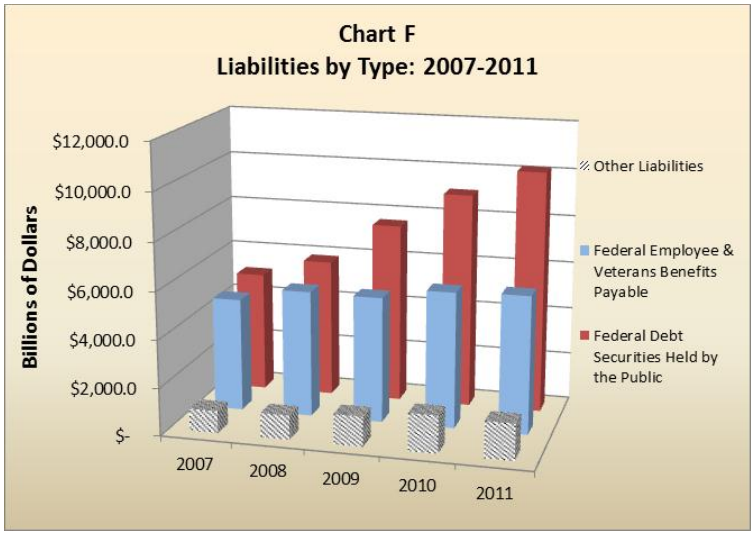
[14] As shown in Table 4, net operating cost includes a slight adjustment for unmatched transactions and balances. These amounts are described in greater detail in the Required Supplementary Information section of this Report.

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 F, the Government's largest liability is Federal debt held by the public and accrued interest, the balance of which increased to $10.2 trillion as of September 30, 2011.

The other major component of the Government's liabilities is Federal employee postemployment and veterans benefits payable (i.e., the Government's pension and other benefit plans for its military and civilian employees), which increased only $71.9 billion or just over 1 percent during FY 2011, from $5,720.3 billion to $5,792.2 billion. OPM administers the largest civilian pension plan, covering nearly 2.8 million current employees[15] and 2.5 million annuitants.[16] The military pension plan covers more than three million current military personnel (including active service, reserve, and National Guard) and approximately 2.2 million retirees and annuitants.[17]



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, and accrued interest, as reported on the Government's balance sheet, is comprised of Treasury securities, such as bills, notes, and bonds, net of unamortized discounts and premiums; and accrued interest payable. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Federal Government. Debt held by the public and accrued interest is a balance sheet liability and totaled approximately $10.2 trillion at the end of FY 2011 – an increase of about $1.1 trillion. As indicated above, budget surpluses have typically resulted in borrowing reductions, and budget deficits have conversely yielded borrowing increases. However, the Government's debt operations are generally much more complex than this would imply. Each year, trillions of dollars of debt matures and new debt is issued to take its place. In FY 2011, new borrowings were $8.0 trillion and repayments of maturing debt held by the public were $6.9 trillion. Both represented slight decreases over new borrowings and debt repayments as compared to FY 2010.

In addition to debt held by the public, the Government has about $4.7 trillion in intragovernmental debt outstanding, 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 ($2.7 trillion) and Medicare ($316.3 billion) trust funds. Intragovernmental debt is primarily held in Government trust funds in the form of special nonmarketable securities by various parts of the Government. Laws establishing Government trust funds generally require excess trust fund receipts (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 government-wide financial statements (see Note 14 of the Report). When

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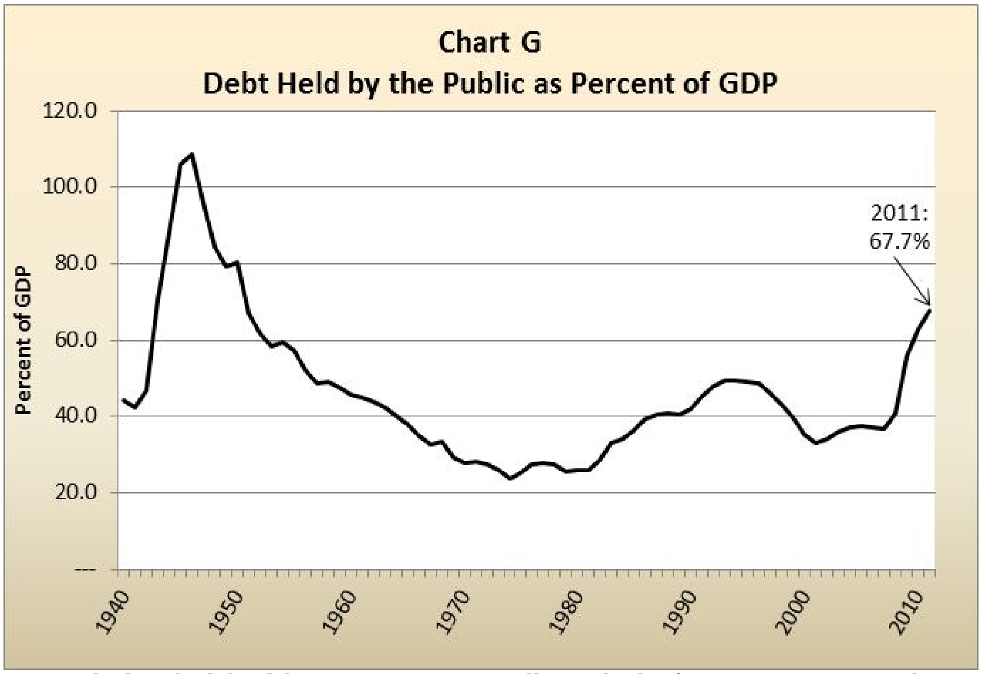
[15] As of 9/30/2010 OPM Office of Actuaries
[16] OPM FY 2011 Annual Financial Report, p. 12.
[17] DOD FY 2011 Agency Financial Report, p.12; DOD Military Retirement Fund (MRF) financial statements, p. 14.

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). At the end of FY 2011, debt subject to the statutory limit was $14.747 trillion, nearly $450 billion under the current limit of $15.194 trillion.

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. Since 1960, Congress has passed 79 separate acts to raise the debt limit, extend the duration of a temporary increase, or revise the definition. The debt limit has been raised multiple times in recent years – most recently by $400 billion in August 2011 to $14.694 trillion and by $500 billion in September 2011 to $15.194 trillion, pursuant to the Budget Control Act (BCA) of 2011. The BCA provides for one additional increase to the debt limit, which will occur fifteen days after the President certifies that the outstanding debt subject to limit is within $100 billion of the debt limit, unless Congress enacts a joint resolution of disapproval. The amount of the next increase will be $1.2 trillion, unless a balanced budget amendment to the Constitution has been submitted to the states for ratification, in which case the amount of the increase will be $1.5 trillion.



The Federal debt held by the public measured as a percent of GDP compares the country's debt to the size of its economy, making this measure sensitive to changes in both. 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 G, wartime spending and borrowing had pushed the debt to GDP ratio to an all-time high of 109 percent in 1946, but it decreased rapidly in the post-war years, falling to 80 percent by 1950, 46 percent in 1960, and the postwar low point of 24 percent in 1974. Since then, the ratio has increased, growing 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 decline in the debt-to-GDP ratio over the course of the 1990s, from a peak of 49 percent in 1993-1994, 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, entitlements were expanded, and spending related to defense and homeland security increased. By September 2008, the debt-to-GDP ratio was 40 percent of GDP. The extraordinary demands of the recent economic and fiscal crisis and the consequent actions taken by the Federal Government, combined with slower economic growth in the wake of the crisis, have pushed the debt/GDP ratio up to almost 68 percent in 2011.

The preceding section has focused on the Federal Government's financial results for FY 2011. The following sections discuss the Government's economic recovery efforts and provide a perspective on the issue of fiscal sustainability.

Economic Recovery Efforts

This section provides an overview of the economy at the end of FY 2011 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 2011

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 continued to grow, albeit at a slower rate during FY 2011. Job growth accelerated, with private non-farm payrolls rising by almost 1.9 million after a gain of nearly 350,000 the previous fiscal year. The unemployment rate declined during FY 2011 but remained relatively high.

Table 6: National Economic Indicators*

	FY 2011	FY 2010
Real GDP Growth	1.5%	3.5%
Residential Investment Growth	1.4%	-7.8%
Average monthly payroll job change (thousands)	158	29
Unemployment rate (percent, end of period)	9.1%	9.6%
Consumer Price Index (CPI)	3.9%	1.1%
CPI, excluding food and energy	2.0%	0.8%
Treasury constant maturity 10-year rate (end of period)	1.9%	2.5%
Moody's Baa bond rate (end of period)	5.2%	5.6%

* Some FY2010 data may differ from the FY2010 Report due to update and revision.

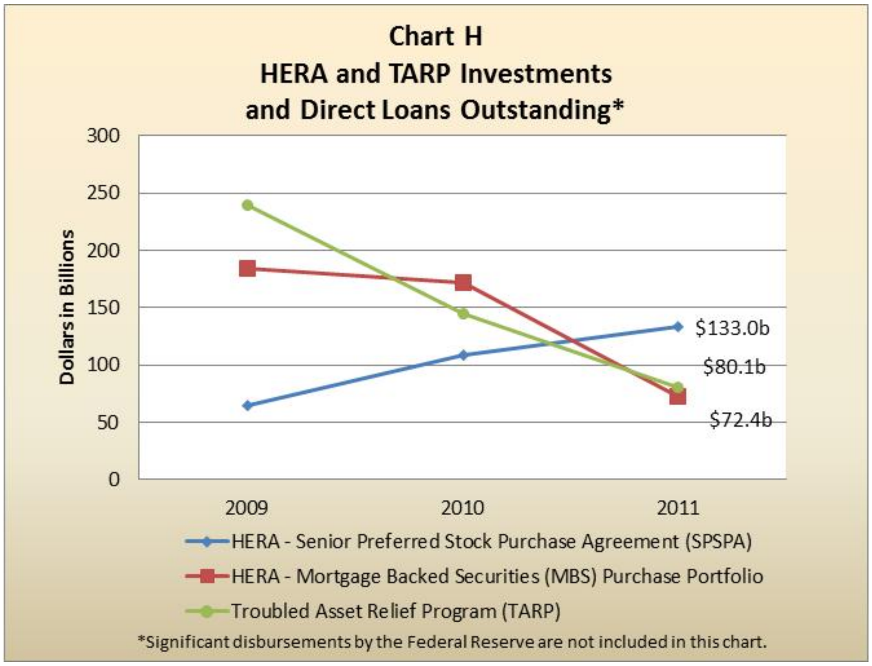
After rising by 3.5 percent during FY 2010, real GDP grew at an annual average rate of 1.5 percent over the four quarters of FY 2011. Quarterly performance was mixed, with real GDP rising 2.3 percent during the first quarter of FY 2011, 0.8 percent on average in the second and third quarters, and 2.0 percent in the fourth quarter of the fiscal year. The economy added 1.6 million total nonfarm payroll jobs during FY 2011, a substantial improvement on the 118,000 nonfarm payroll jobs added during FY 2010. In the private sector, nonfarm payrolls rose by about 1.9 million, after increasing by nearly 350,000 during the previous fiscal year. Nonetheless, the unemployment rate remained elevated in the aftermath of the financial crisis during FY 2011, declining from 9.6 percent in September 2010 to 9.1 percent in September 2011. Inflation increased for the second straight year, mainly reflecting increases in energy and food prices, but still remained contained. Underlying inflation (the core rate, excluding food and energy) also increased but was still low by historical standards. Real wages declined, reflecting the combination of slower nominal wage growth and rising consumer prices. The level of corporate profits increased in FY 2011, but at a slower pace than in the previous fiscal year. Growth of Federal spending and receipts accelerated in FY 2011. As a result, the Federal unified budget deficit was little-changed at $1.3 trillion but narrowed as a share of GDP to 8.7 percent of GDP from 9.0 percent in FY 2010.

The following key points summarize economic performance in FY 2011:

- Consumer spending rose 2.2 percent for a second straight fiscal year during FY 2011. Nonetheless, quarterly performance ranged from a solid 3.6 percent annualized increase in the first quarter of FY 2011 to a more tepid 0.7 percent annualized increase in the third quarter.
- Residential fixed investment started to recover in the latest fiscal year, growing by 1.4 percent over the four quarters of FY 2011, with growth recorded in all but one quarter. Nonresidential fixed investment grew 8.9 percent, after rising by 7.7 percent during the previous fiscal year.
- Labor market conditions improved noticeably during FY 2011, despite a moderation in the pace of job growth towards the end of the fiscal year. Over the entire fiscal year, private nonfarm payroll employment advanced at an average rate of 158,000 jobs per month, compared with an average monthly increase of 29,000 in FY 2010. During FY 2011, the number of unemployed persons fell from 14.7 million to 14.0 million. The unemployment rate stood at 9.1 percent in September 2011, down from 9.6 percent at the end of FY 2010, or 0.5 percentage point lower. At the end of FY 2011, the unemployment rate was a full percentage point lower than the recent peak of 10.1 percent, reached in October 2009.

- The overall price level, as measured by the consumer price index (CPI), rose 3.9 percent during FY 2011, boosted by rising energy and food prices. In FY 2010, the CPI had increased by 1.1 percent. Core inflation (which excludes food and energy) was 2.0 percent in FY 2011, compared with 0.8 percent the previous fiscal year.
- Financial markets conditions and measures of financial risk generally remained stable in FY 2011:
  - Corporate debt yields on bonds of moderate risk stood at about 305 basis points above the rate on 10-year Treasury securities at the end of FY 2010. After narrowing through much of the following fiscal year, the spread widened somewhat during the final quarter of FY 2011 and ended the fiscal year at 330 basis points.
  - The difference between the 3-month London Interbank Offered Rate (LIBOR) and the 3-month Treasury rate stood at 13 basis points at the end of FY 2010. This spread widened over the course of the latest fiscal year, ending FY 2011at 43 basis points.

Review of the Government's Stabilization Efforts



Three years ago, the U.S. financial system was on the verge of collapse and many major financial institutions were at risk of failure. Markets had ceased to function. Without immediate and forceful government action, our country faced the possibility of a second Great Depression. 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 potential collapse and continue to administer a number of programs to help pave the way for sustained economic recovery. Three years later, substantial progress continues to be made in stabilizing the financial system as the Government continues to wind down the extraordinary assistance that was provided during the crisis. Chart H summarizes the outstanding balances of investments and direct loans related to key economic recovery programs.

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),[18] 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 undertook certain efforts to help ensure the solvency and liquidity of the GSEs, including:

- entering into senior preferred stock purchase arrangements (SPSPAs) with Fannie Mae and Freddie Mac;
- establishing a GSE mortgage-backed securities (MBS) purchase program (expired on December 31, 2009).

[18] 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. The obligations of the housing GSEs are not guaranteed by the Federal Government, however, Treasury's actions under HERA provided significant financial support to Fannie Mae and Freddie Mac.

The SPSPAs are intended to maintain the solvency of the GSEs so they can continue to fulfill their vital roles in the mortgage market while the Administration and Congress determine what structural changes should be made. 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 exceeds its respective assets. GSE funding is subject to a formulaic cap that adjusts upwards quarterly by the cumulative amount of any losses realized by either GSE and downward by the cumulative amount of any gains, but not below $200 billion per GSE, and will become fixed on December 31, 2012. At that time, the remaining commitment will then be fixed and available to be drawn per the terms of the agreements. As of September 30, 2011, Treasury had made total actual cumulative combined payments to Fannie Mae and Freddie Mac of $169.0 billion, reflected on the Government's balance sheet at fair value of $133.0 billion (see Chart H). In addition, a combined $316.2 billion has been accrued as a contingent liability for future SPSPA investments in the GSEs, a $44 billion decrease from FY 2010, following a $268 billion increase between 2009 and 2010. The significant increase in this liability in FY 2010 was due primarily to the increased availability of GSE projection data, coupled with the effect of the 2009 amendment to the liquidity cap for each GSE. The decrease in FY 2011 was attributable to payments to the GSEs and updated projections reflecting lower expected future losses at the GSEs.

The GSE Mortgage-Backed Securities (MBS) Purchase Program was created to broaden access to mortgage funding for current and prospective homeowners and to promote stability in the mortgage market. Between October 2008 and December 31, 2009, Treasury purchased $225 billion in agency MBS. In March 2011, Treasury announced its plans to sell up to $10 billion of its MBS portfolio per month, subject to market conditions. As a result of these sales and prepayments, the outstanding MBS portfolio decreased by more than half from $172.2 billion at the end of FY 2010 to $72.4 billion at the end of FY 2011 (see Chart H) and by more than two-thirds when compared to Treasury's initial purchases. Treasury's efforts 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.

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 (OFS) within the Treasury Department to implement the Troubled Asset Relief Program (TARP). TARP, in conjunction with other Federal Government actions, helped to prevent a collapse of the financial system and 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 many anticipated.

The EESA originally provided authority for the TARP to purchase or guarantee up to $700 billion in troubled assets. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 reduced the cumulative TARP authority to $475 billion. On October 3, 2010, OFS' authority to make new commitments under TARP expired. During FY 2011, OFS focused principally on exiting remaining investments in a timely and orderly manner, maximizing return for taxpayers, and continuing to help homeowners avoid preventable foreclosures:

- The TARP programs launched to help stabilize the nation's banking institutions are now producing a profit to taxpayers. A total of $245 billion was invested in banking institutions pursuant to several TARP initiatives, compared to approximately $258 billion that OFS has recovered through repayments, dividends, interest, and other income since TARP's inception through September 30, 2011.

- OFS reduced its stake in General Motors Company by 50 percent through General Motors' highly successful Initial Public Offering and fully exited its investment in Chrysler Group, as Chrysler Group repaid its loans six years earlier than the loans' maturity dates.

- OFS, working with other Federal Government entities, closed a major restructuring plan for American International Group (AIG), marking a major milestone in the company's turnaround and putting OFS in a better position to recover their investment in AIG. In May 2011, Treasury completed the sale of 132 million shares of AIG common stock held by OFS and 68 million shares held by the General Fund. As of September 30, 2011, OFS held 960 million shares and the General Fund held an additional 495 million shares of AIG common stock, resulting in a combined percentage ownership of AIG's outstanding shares of approximately 77 percent.

As a result of improved financial conditions of TARP participants, earlier than expected asset repurchases, lower utilization of the program, and careful stewardship, the estimated cost of TARP over its lifetime continues to decline on a budget basis, from $341 billion in August 2009 (assuming the full $700 billion of TARP authority was utilized), to $117 billion in February 2010 (assuming $546 billion of the $700 billion TARP authority was utilized). The most recent estimates as of September 30, 2011, reflect a lifetime cost of $70.2 billion on $470 billion of TARP authority that was obligated. These budget-basis estimates, which assume that all planned expenditures are made, differ from the cost reported in the financial statements, which are based on transactions through September 30, 2011, and thus, do not include committed but undisbursed funds for housing programs as well as other programs all of which are included in the expected lifetime cost for budget purposes. TARP's costs from inception (October 3, 2008), through September 30, 2011, as reported in the OFS financial statements, were $28.0 billion.

Since its inception through September 30, 2011, OFS has disbursed $413.4 billion in direct loans and investments and for the Treasury Housing programs under TARP, collected $276.9 billion from repayments and sales, and reported nearly $40 billion from cash received through interest and dividends, as well as from proceeds from the sale and repurchase of assets in excess of cost. As of September 30, 2011, TARP had $122.4 billion in gross outstanding direct loans and equity investments, valued at $80.1 billion (see Chart H).

It should be noted that TARP cost estimates are based on current market prices, where available. 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 has 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 was to jump-start the economy and to create and save jobs, with one-third of ARRA dedicated to tax provisions to help businesses and working families, another third for emergency relief for those who have borne the brunt of the recession, and the final third 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, 2011 totaled $421.4 billion, as compared to $307.9 billion as of September 30, 2010.[19] 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.

[19] Agency Financial & Activity Reports as of September 30, 2011 and 2010. For more information, see the Recovery Act website at www.Recovery.gov.

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

While the Government's immediate priority is to continue to foster economic recovery, 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 (publicly-held debt) 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.[20] The projections are therefore neither forecasts nor predictions. If policy changes are enacted, then actual financial outcomes will of course be different than those projected.

The projections in this Report indicate that the trajectory of current policy is not sustainable. The debt-to-GDP ratio is projected to reach 287 percent in 2086 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 1.8 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 estimated that the magnitude of reforms necessary to close the 75-year fiscal gap is 60 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.

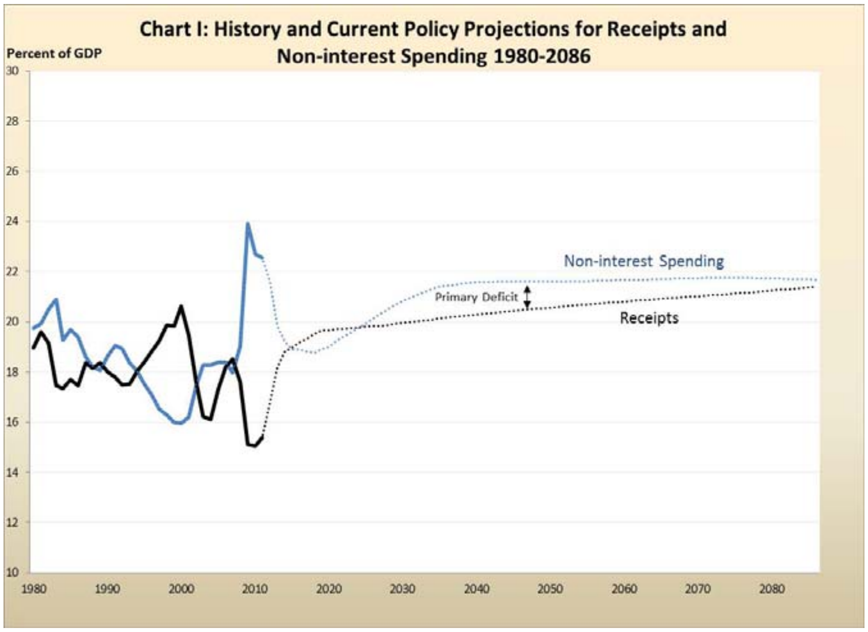
The estimates of the cost of policy delay in this Report assume policy does not affect GDP (or interest rates). Reducing deficits too abruptly would be counterproductive if it slows the economy's recovery. In the near term, it is crucial to strike the proper balance between deficit reduction and economic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

The Primary Deficit, Interest, and Debt

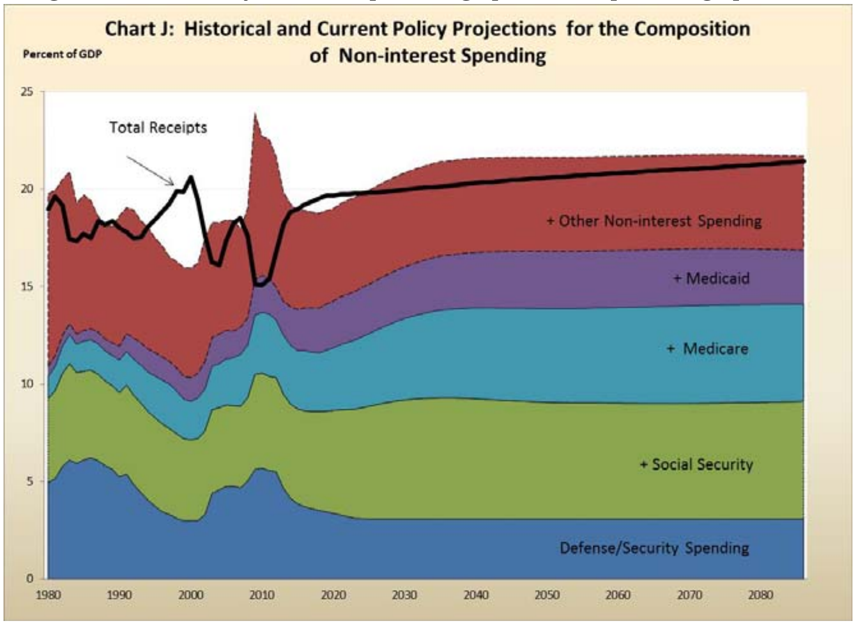
The primary deficit - the difference between non-interest spending and receipts – is the only determinant of the ratio of publicly-held debt to GDP that the Government controls directly. (The other determinants are interest rates and growth in GDP). Chart I shows receipts, non-interest spending, and the difference – the primary deficit – expressed as a share of GDP. The primary deficit-to-GDP ratio grew rapidly in 2009 and stayed large in 2010 and 2011 due to the financial crisis and the recession and the policies pursued to combat both. The primary deficit-to-GDP ratio is projected to fall rapidly between 2012 and 2019 (turning to surplus in 2015) as spending reductions called for in the Budget Control Act (BCA) of 2011 take effect and the economy recovers. Between 2019 and 2035, however, increased spending for Social Security and health programs due to continued aging of the population is expected to cause the primary balance to steadily deteriorate. A primary deficit is expected to reappear in 2025 that reaches 1.3 percent of GDP in 2035. After 2035, the projected primary deficit-to-GDP ratio slowly declines as the impact of the baby boom generation retiring dissipates. Between 2035 and 2086, the projected primary deficit averages 0.9 percent of GDP.

[20] Current policy in the projections is based on current law, but includes extension of certain policies that expire under current law but are routinely extended or otherwise expected to continue, such as extension of relief from the Alternative Minimum Tax (AMT).

The revenue share of GDP fell substantially in 2009 and 2010 and increased only modestly in 2011 because of the recession and tax reductions enacted as part of the ARRA and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and is projected to return to near its long-run average as the economy recovers and these temporary 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 more taxpayers and a larger share of income to fall into the 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.

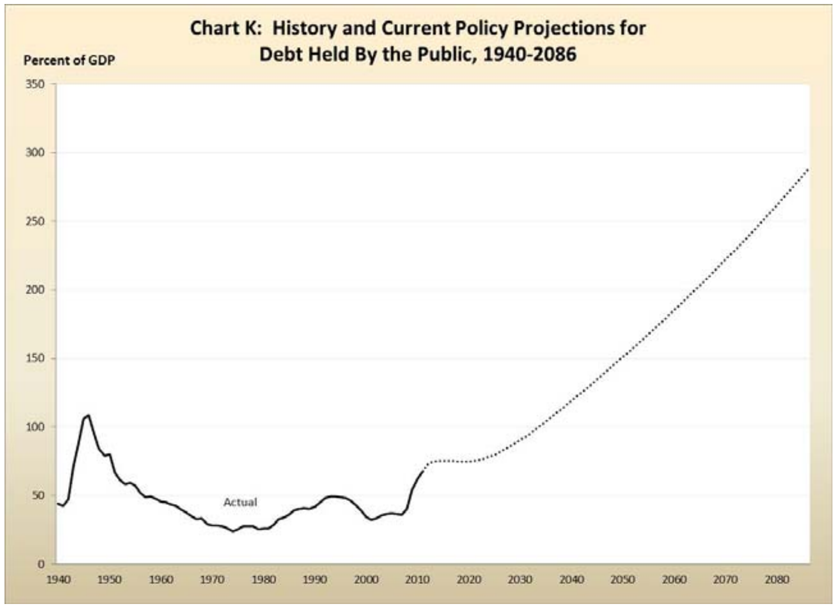


Non-interest spending share of GDP is projected to fall from its current level of 22.6 percent to about 20 percent in 2013, to stay at or below that level until 2026, and then to rise gradually and plateau at about 22 percent beginning in about 2040. The reduction in the non-interest spending share of GDP over the next two years is mostly due to caps on discretionary spending and further automatic spending reductions enacted in the BCA, and the subsequent increase is principally due to growth in Medicare, Medicaid, and Social Security spending. (See Chart J.) The retirement of the baby boom generation over the next 25 years is projected to increase the Social Security, Medicare, and Medicaid spending shares of GDP by about 1.4 percentage points, 1.3 percentage points, and 1.0 percentage points, respectively. After 2035, the Social Security spending share of GDP is relatively steady, while the Medicare and Medicaid spending share of GDP continues to increase, albeit at a slower rate, due to projected increases in health care costs. The Affordable Care Act (ACA)[21] significantly reduces projected Medicare and Medicaid cost growth from the levels projected in the 2009 Financial Report. However, there is uncertainty about whether the projected cost savings, productivity improvements, and reductions in physician payment rates will be sustained in a manner consistent with the projected cost growth over time.

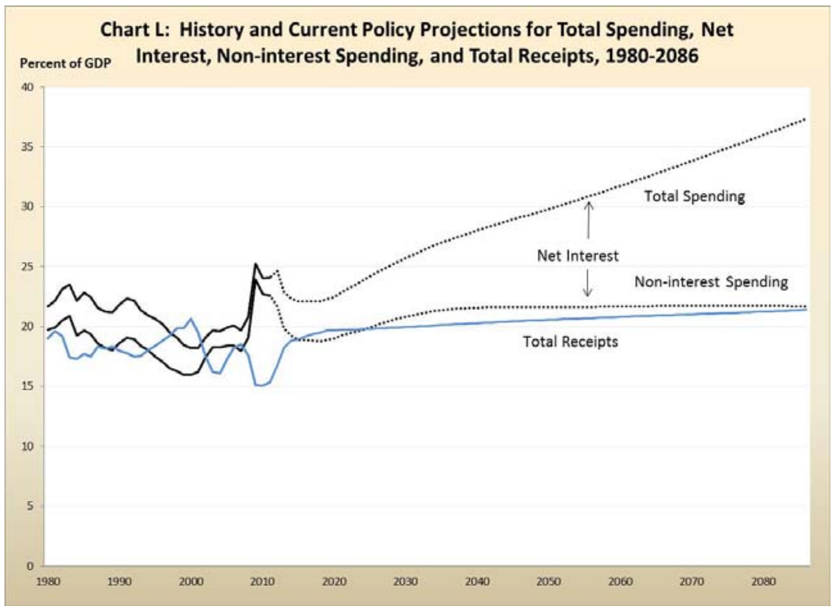


[21] P.L. 111-148 as amended by P.L. 111-152.

The primary deficit projections in Chart I, along with those for interest rates and GDP, determine the projections for the ratio of publicly-held debt to GDP that are shown in Chart K. That ratio was 68 percent at the end of fiscal year 2011 and under current policy is projected to exceed 76 percent in 2022, 125 percent in 2042, and 287 percent in 2086. This continuous rise of the debt-to-GDP ratio illustrates that current policy is unsustainable.



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 L 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 1.5 percent of GDP in 2011 and under current policies is projected to reach 5 percent in 2031 and nearly 16 percent in 2086.



This year's projections are somewhat more favorable than were the projections in the 2010 Financial Report. Last year's report projected a debt-to-GDP ratio to reach 352 percent in 2085, which compares with 283 percent projected in this year's report. The more favorable outlook is mainly due to spending reductions called for in the BCA that are partly offset by somewhat less favorable economic and technical assumptions.

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 1.1 percent of GDP. This compares with an average primary deficit of 0.7 percent of GDP under current policy. The difference, the "75-year fiscal gap," is 1.8 percent of GDP, which is about 9 percent of the 75-year present value of projected receipts and non-interest spending.

Table 7: Costs of Delaying Fiscal Consolidation

Period of Delay	Change in Average Primary Surplus
No Delay: Reform in 2012	1.8 percent of GDP between 2012 and 2086
Ten Years: Reform in 2022	2.2 percent of GDP between 2022 and 2086
Thirty Years: Reform in 2032	2.8 percent of GDP between 2032 and 2086

Note: Reforms taking place in 2011, 2021, and 2031 from the 2010 Report were 2.4, 2.9, and 3.7 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 1.8 percent of GDP in every year between 2012 and 2086.

This is accomplished by invoking some combination of spending reductions and revenue increases that amounts to an average of 1.8 percent of GDP in every year. The second policy shown in Table 7 begins in 2022. Because debt grows unabated between 2011 and 2021 and the same fiscal consolidation must be compressed into 10 fewer years, the primary surplus must increase by 2.2 percent of GDP in every year between 2022 and 2086 in order to close the 75-year fiscal gap. Similarly, beginning the policy change in 2032 requires that the primary surplus increase by 2.8 percent of GDP in every year between 2032 and 2086 in order to close the 75-year fiscal gap. The difference between the primary surplus boost starting in 2022 and 2032 (2.2 and 2.8 percent of GDP, respectively) and the primary surplus boost starting in 2012 (1.8 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 the primary surplus is during their lifetimes the greater the difference is between the taxes they pay and the programmatic spending they benefit from.

Conclusion

The United States took potentially significant steps towards fiscal sustainability by enacting the ACA in 2010 and the BCA in 2011. The ACA holds the prospect of lowering the long-term growth trend for Medicare and Medicaid spending, and the BCA significantly curtails discretionary spending. Together, these two laws substantially reduce the estimated 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 – Challenges Continue

The preceding analysis of the Government's long-term fiscal projections considered Government receipts and spending as a whole. A more focused perspective can be achieved through analysis of the Government's "social insurance" programs: Social Security, Medicare, Railroad Retirement, and Black Lung. For these programs, 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

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

Dollars in Billions	2011	2010	Increase / (Decrease) $	Increase / (Decrease) %
Open Group (Net):				
Social Security (OASDI)	$ (9,157)	$ (7,947)	$ 1,210	15%
Medicare (Parts A, B, & D)	$ (24,572)	$ (22,813)	$ 1,759	8%
Other	$ (101)	$ (97)	$ 4	4%
Total Social Insurance Expenditures, Net (Open Group)	**$ (33,830)**	**$ (30,857)**	$ 2,974	10%
Total Social Insurance Expenditures, Net (Closed Group)	**$ (46,273)**	**$ (43,057)**	$ 3,217	7%

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

Open Group	**2011**	**2010**
Social Security (OASDI)	-1.0%	-0.9%
Medicare (Parts A, B, & D)	-2.8%	-2.7%
Other	0.0%	0.0%
Total (Open Group)	**-3.8%**	**-3.7%**
Total (Closed Group)	**-5.3%**	**-5.1%**

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 2011 & 2010 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 'Other' and Total Net Social Insurance Expenditures as % of GDP.

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

information in this Report are based on each program's official actuarial calculations. By accounting convention, the transfers of general revenues are eliminated in the consolidation of the financial statements at the government-wide 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. SOSI programs and amounts are included in the broader fiscal sustainability analysis in the previous section, although on a slightly different basis (as described in the Supplemental Section of this Report).

The SOSI provides perspective on the Government's long-term estimated exposures and costs for social insurance programs. 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.

Table 8 on the previous page, which summarizes amounts reported in the SOSI, shows that net social insurance expenditures are projected to be approximately $34 trillion as of January 1, 2011 for the "Open Group," an increase of approximately $3 trillion over net expenditures of $31 trillion projected in the 2010 Report.[22] Table 9 summarizes the principal reasons for the changes in projected social insurance amounts during FY 2011. Most of the change from the past year is attributable to the change in valuation period. For a 75-year projection period, the change in valuation period measures the effect of replacing the first projection year from the prior year with a new 75th year in the current reporting year. Another significant variable was changes in demographic (e.g., birth, mortality, and immigration) and economic (e.g., taxable earnings, unemployment, and interest rates) assumptions. For the Old-Age, Survivors, and Disability Insurance (OASDI) programs administered by the Social Security Administration, the largest component for change was the change in demographic assumptions. For the Medicare programs (Parts A, B, and D) the most significant components of change were the changes in valuation period and in economic assumptions.

As was reported in the FY 2010 Financial Report of the U.S. Government, projected Medicare costs declined significantly reflecting provisions of the ACA. As reported last year and again this year in Note 26, there continues to be 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. As indicated earlier, GAO disclaimed opinions on the 2011 and 2010 SOSI, because of these significant uncertainties.

Table 9: Changes in Social Insurance Projections

Dollars in Billions		
Net Present Value (NPV) - Open Group (FY 2010)		(30,857)
Change In:		
Valuation Period	$	(1,518)
Demographic data and assumptions	$	(859)
Economic data and assumptions	$	(145)
Law or policy	$	(14)
Methodology and programmatic data	$	56
Economic and other healthcare assumptions	$	(463)
Change in projection base	$	(31)
Net Change in Open Group measure	$	(2,974)
NPV - Open Group (FY 2011)		(33,830)

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, under current law, including the assumption of the full implementation of ACA program changes, spending on Medicare is projected to rise from 3.7 percent of GDP in 2011 to 5.6 percent in 2035 and 6.2 percent in 2085. The Hospital Insurance (HI) Trust Fund is now expected to remain solvent until 2024, five years earlier than estimated in last year's report, after which point tax income is estimated to be sufficient to pay 90 percent of benefits, declining to 76 percent in 2050 and then increasing to 88 percent by 2085.

As for Social Security (the Old-Age, Survivors, and Disability Insurance Trust Funds or OASDI), combined spending is projected to increase gradually from its current level of 4.8 percent of GDP to 6.2 percent in 2035, declining to about 6.0 percent by 2050 and remaining at about that level through 2085. The Social Security

[22] '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.

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 2023, 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 2036, one year earlier than estimated in the prior year's Trustees' Report. After trust fund exhaustion, continuing tax income would be sufficient to pay 77 percent of scheduled benefits in 2036 and 74 percent in 2085.[23]

As noted earlier, it is apparent that these programs are on a fiscally unsustainable path (as was previously discussed and as noted in the Trustees' Reports). Additional information from the Trustees Reports may be found in the Supplemental Information section of this Report.

Systems, Controls, and Legal Compliance

Systems

As Federal agencies demonstrate success in obtaining opinions 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 2011 remains at 17, and the number of auditors reporting compliance with FFMIA reduced to 13, compared to 14 in FY 2010. 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, as amended by the Improper Payments Elimination and Recovery Act, which includes the measurement, reporting, recovery, and remediation of improper payments.

In addition to the FY 2011 agency financial statement audit results, the total number of material weaknesses for Chief Financial Officers (CFO) Act agencies remained steady at 31. Effective internal controls are a challenge not only at the agency level, but also at the government-wide level. GAO reported that at the government-wide 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.

[23] A Summary of the 2011 Annual Social Security and Medicare Trust Fund Reports, p. 10.

Financial Management Progress and Priorities

The Office of Federal Financial Management (OFFM) within the Office of Management and Budget (OMB) is responsible for the Federal Government's financial management policy and manages government-wide financial management priorities. 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. This year, for the first time since the passage of the CFO Act over 20 years ago, 23 of the 24 CFO Act agencies obtained an opinion from the independent auditors on their financial statements.[24] 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. Out of the 24 major "CFO Act" agencies, there were 21 clean opinions, 2 qualified opinions, and only one remaining disclaimer in FY 2011. In addition, the number of auditor-identified material weaknesses stands at 31, an approximate 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 No. 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 and other limitations continue to prevent one major agency, and the Government as a whole, from achieving an 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 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 $115 billion in improper payments in FY 2011 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. However, initiatives as outlined below are resulting in progress with these issues and are putting the Government in a better position.

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 –** The President launched the Campaign to Cut Waste last summer to reduce costs, identify and implement efficiencies, and root out wasteful expenditures across government. Building on this effort, the

[24] The Department of Homeland Security had the Balance Sheet and the Statement of Custodial Activity audited and received a qualified opinion on these statements. The Department of State received a clean opinion on the Statements of Net Costs and the Statement of Budgetary Resources, and a qualified opinion on the Balance Sheet and Statement of Changes in Net Position. HHS received a clean opinion on all statements except the Statement of Social Insurance and the Statement of Changes in Social Insurance, both of which received a disclaimer of opinion. The Department of Defense received a disclaimed opinion on all statements subject to audit.

Federal Government will continue to focus on removing unneeded real property from the Government's books and eliminating improper payments.

- **Closing the Efficiency and Technology Gap in Financial Operations** – The Federal Government are working to simplify the governance structure in an effort to unify the grants community and strengthen the audit framework for Federally-funded State and local activities. In February, the President issued a memorandum directing OMB to work with stakeholders to improve Federal grants management. In addition, 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

- *Campaign to Cut Waste.* In an effort to reduce costs, identify and implement efficiencies, eliminate practices that are antiquated and unnecessary, and root out waste across government, the President launched the Campaign to Cut Waste in June of 2011. Executive Order 13576 "*Delivering an Efficient, Effective, and Accountable Government,*" which established the Campaign to Cut Waste, called upon all agencies to reinforce the performance and management reform gains already achieved; systematically identify additional reforms necessary to eliminate wasteful, duplicative or otherwise inefficient programs; and publicize these reforms so that they may serve as a model across the Federal Government. Building on this effort, the President issued an Executive Order on "Promoting Efficient Spending" that requires agencies to cut certain administrative costs in FY 2013 by not less than 20 percent below FY 2010 levels. The Chief Financial Officers at each of the agencies are largely responsible for achieving these savings. The CFO Council is responsible for reporting the result of these efforts to the President's Management Council. These efforts under the Campaign to Cut Waste are expected to result in billions of dollars in savings by FY 2013.
- *Accelerating Efforts to Better Manage Federal Real Property.* The Administration is focused on improving the management of real property assets. The Federal Government is the largest property owner in the country, but it is not using some of those assets productively. The Administration supports efforts to remove unneeded real property from the Government's books and reduce operating costs related to real 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 and to realize $3 billion in savings from the Government's properties by September 30, 2012. To date, Federal agencies have identified $1.5 billion of the President's $3 billion goal through actions including reducing annual operating costs, reducing square footage through consolidating space within owned and leased buildings, increasing the impact of telework, selling owned properties, and improving energy efficiencies. To build on this effort and work in achieving more long-term savings, the President introduced the Civilian Property Realignment Act in the FY 2012 budget. The proposal would create an independent Board to reduce and realign the Federal civilian property inventory. The Board would cut bureaucratic red tape, resolve longstanding competing stakeholder interests, and help address the financial challenges that hinder efforts to dispose and consolidate Federal real property. Expanding on the work toward the passage of the President's proposal, the Administration has continued to make progress on achieving savings in real property by working with the Federal Real Property Council and the Real Property Advisory Committee to encourage greater collaboration across agencies.
- *Addressing Improper Payments.* The Improper Payments Information Act of 2002 (IPIA) as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA), 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 and overpayment recoveries are pursued. Addressing improper payments is a central component of Administration efforts to eliminate waste. Over the past two years, 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 of 2010 (IPERA), which amends IPIA. While agencies are continuing to

implement these initiatives, we are already seeing real results. Based on information submitted by agencies in FY 2011, the reported government-wide error rate is 4.69 percent, a decrease from the FY 2010 rate of 5.29 percent. The estimated improper payments reported for FY 2011 are $18 billion lower than if the error rate had remained at the higher rate of 5.42 percent reported for FY 2009, the first year of improper payment reporting under the Administration. In addition, agencies reported recapturing more than $1.2 billion in improper payments to contractors and vendors in FY 2011, almost twice as much as was recaptured in FY 2010. More information on agency improper payments and the Administration's improper payment initiatives can be found at PaymentAccuracy.gov.

Closing the Efficiency and Technology Gap in Financial Operations

- *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. OFFM is 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. On February 28, 2011, the President issued a Memorandum instructing OMB to work with Federal and non-Federal stakeholders to review OMB Circulars and look for ways to reduce administrative burden for recipients while improving program outcomes for Federal grants. OFFM convened two working groups, one focusing on Cost Principles and Audit Requirements for States, Localities, and Tribes, and another to look at the same policies for universities. The recommendations of these two groups were submitted to OMB at the end of August. On October 27, 2011, OMB issued M-12-01, creating the Council on Financial Assistance Reform (COFAR) to provide policy level leadership for the grants community to implement much needed reforms to improve effectiveness and efficiency in Federal grants. The COFAR is working to develop these reforms based on the recommendations received from the grants community.
- *Decreasing the Cost of Financial System Modernizations*. Complexity and inefficiency in the Federal Government's financial management operations has led to an increasingly expensive environment for modernizing financial systems. Also, once deployed, the Federal Government's modern systems do not consistently meet our business needs or produce the right information to support decision-making. In June 2010, OMB froze activity on CFO Act agency financial system plans pending their immediate review and approval. To date, a total of 21 agencies have been reviewed and, where appropriate, the agencies have realigned 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. These realignments have resulted in cost reductions for some of the projects reviewed. Review of the agency financial system projects continues according to the risk associated with the projects. In addition, Customer Control Boards were established 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.

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. Under the Administration's Campaign to Cut Waste, the President's June 13, 2011 Executive Order (EO), "Delivering an Efficient, Effective, and Accountable Government" established the Government Accountability and Transparency Board (GATB). Under the EO, the Board is charged with providing recommendations to the President on enhancing the transparency of Federal spending and advance fraud detection efforts, data quality and fraud detection. These recommendations will leverage the experience and lessons learned from the implementation of the Recovery Act and the Recovery Accountability and Transparency Board (RATB). 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 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. 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. Access to both prime and now sub-award data offers the public 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.

- *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 in 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 is currently being piloted and will establish reliable reporting of how taxpayer dollars are being spent.
- *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: (1) improve payment accuracy; (2) improve administrative efficiency; (3) improve service delivery; and (4) 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. So far, six pilots have been funded and are being implemented by lead Federal agencies in cooperation with state partners. These pilots address multiple programs, including the Supplemental Nutrition Assistance Program (SNAP), Unemployment Insurance, Medicaid, the Earned Income Tax Credit (EITC), and the Treasury Offset Program.

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 reported government-wide improper payment rate, from 5.29 percent in FY 2010 to 4.69 percent in FY 2011 and increasing the amount of recaptured improper payments by approximately 80 percent. In addition, the agencies are on target to exceed the goal of $3 billion in savings from real property by September 30, 2012. The steps outlined above leverage the tools and capacities in place today, and 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.

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