MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The fiscal year (FY) *2008 Financial Report of the United States Government (Report)* provides the President, Congress, and the American people a comprehensive view of the Federal Government's finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The Report also discusses important financial issues and significant conditions that may affect future operations. This year's Report gives particular emphasis to two key issues: The Government's response in recent months to the financial market crisis, and the Government's capacity to sustain the funding and pay the benefits of key social insurance programs, such as Social Security and Medicare.

Pursuant to 31 U.S.C. § 331(e)(1), the Department of the Treasury must submit the Report, which is subject to audit by the Government Accountability Office (GAO), to the President and Congress no later than six months after the September 30 fiscal year-end. To encourage timely and relevant reporting, the Office of Management and Budget (OMB) accelerated both agency and governmentwide reporting deadlines to 45 days and 75 days after year-end, respectively.

FY 2008 Agency Audit Results				
Unqualified				Disclaimer
USDA	HUD	DoT	NSF	
Commerce	Interior	VA	NRC	Defense
Education	Justice	USAID	OPM	DHS [1]
Energy	Labor	EPA	SBA	State
HHS	Treasury	GSA	SSA	NASA

[1] Balance Sheet and Custodial Statement Audit Only

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). For FY 2008, GAO has issued a 'disclaimer' of opinion on the accrual-based consolidated financial statements, as it has for the past eleven years, for the fiscal years (FY) ended September 30, 2008 and 2007. This means that sufficient information was not available for the auditors to determine whether the financial results were reliable. In FY 2008, 20 of 24 of the most significant agencies earned unqualified opinions on the financial statement audits. In addition, the Government earned an unqualified audit opinion on a Report component - the Statement of Social Insurance (SOSI) - for the second year in a row, indicating the auditor's opinion that the SOSI fairly presents the financial condition of the programs covered in that statement.

The FY 2008 *Financial Report* consists of:

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

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

Mission & Organization

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

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

Exhibit 1

THE UNITED STATES GOVERNMENT

THE CONSTITUTION

LEGISLATIVE BRANCH

THE CONGRESS
SENATE HOUSE

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

EXECUTIVE BRANCH

THE PRESIDENT
THE VICE PRESIDENT
EXECUTIVE OFFICE OF THE PRESIDENT

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

JUDICIAL BRANCH

THE SUPREME COURT OF THE UNITED STATES

United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims
United States Court of Appeals for the Armed Forces
United States Tax Court
United States Court of Appeals for Veterans Claims
Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission

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

INDEPENDENT ESTABLISHMENTS AND GOVERNMENT CORPORATIONS

African Development Foundation
Broadcasting Board of Governors
Central Intelligence Agency
Commodity Futures Trading Commission
Consumer Product Safety Commission
Corporation for National and Community Service
Defense Nuclear Facilities Safety Board
Environmental Protection Agency *
Equal Employment Opportunity Commission
Export-Import Bank of the U.S. *
Farm Credit Administration
Farm Credit System Insurance Corporation *
Federal Communications Commission *
Federal Deposit Insurance Corporation *
Federal Election Commission
Federal Housing Finance Board
Federal Labor Relations Authority
Federal Maritime Commission
Federal Mediation and Conciliation Service
Federal Mine Safety and Health Review Commission
Federal Reserve System
Federal Trade Commission
General Services Administration *
Inter-American Foundation
Merit Systems Protection Board
National Aeronautics and Space Administration *
National Archives and Records Administration
National Capital Planning Commission
National Credit Union Administration *
National Foundation on the Arts and the Humanities
National Labor Relations Board
National Mediation Board
National Railroad Passenger Corporation (Amtrak)
National Science Foundation *
National Transportation Safety Board
Nuclear Regulatory Commission *
Occupational Safety and Health Review Commission
Office of the Director of National Intelligence
Office of Government Ethics
Office of Personnel Management *
Office of Special Counsel
Overseas Private Investment Corporation
Peace Corps
Pension Benefit Guaranty Corporation *
Postal Rate Commission
Railroad Retirement Board *
Securities and Exchange Commission *
Selective Service System
Small Business Administration *
Smithsonian*
Social Security Administration *
Tennessee Valley Authority *
Trade and Development Agency
U.S. Agency for International Development *
U.S. Commission on Civil Rights
U.S. International Trade Commission
U.S. Postal Service *

*Significant entities included in the FY 2008 Financial Report of the U.S. Government

The Government's Financial Condition

A complete assessment of the Government's financial or fiscal condition requires analysis of historical results, projections of future revenues and expenditures, and an assessment of the Government's long-term fiscal sustainability. As discussed later in this Report, the Government's financial statements show its financial position at the end of the fiscal year, explain how and why the financial position changed during the year, and provide insight into how the Government's financial condition may change in the future. In particular, the Statement of Social Insurance (SOSI) compares the actuarial present value of the Government's anticipated expenditures for future scheduled benefits to its expected collections (e.g., taxes and premiums) for Social Security, Medicare, and other social insurance programs over a 75-year period. Expected expenditures for other major programs, including defense, Medicaid and education, and future tax revenues, while not presented in the SOSI, will also affect the Government's future fiscal condition, as will the Government's recent efforts to stabilize the economy.

What Does This Mean to Me?
2008 marked a departure from the recent pattern of declining deficits. Market stabilization efforts are expected to contribute to potentially substantial deficit increases in the coming year.

The natural starting point for assessing the Government's long-term financial condition is its current financial position, both in absolute 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. It serves as a useful indicator of the economy's capacity to sustain the Government's many programs. For example, in FY 2008:

- Government cash-based outlays of $3.0 trillion, net of receipts of $2.5 trillion (approximately 21 percent and 18 percent of GDP, respectively) yielded a record unified budget deficit for FY 2008 of $454.8 billion. Similarly, the Government's net operating cost more than tripled – from $275.5 billion in FY 2007 to just over $1 trillion in FY 2008.
- The Government borrows from the public to finance the gap between cash-based outlays and receipts (commonly referred to as the unified 'budget deficit'). The value, including interest, of publicly held debt was 40.8 percent of GDP at the end of FY 2008.
- The social insurance programs and Medicaid have become a large share of Government cash-based expenditures. Forty years ago, Medicare, Medicaid, and Social Security accounted for 16 percent of total Government expenditures. Today, they comprise 40 percent of all expenditures.

The following pages contain a more detailed discussion of the budget, the economy, and the debt, as well as a long-term view of the Government's ability to meet its obligations for social insurance and market stabilization.

Budget Deficit vs. Net Cost

Each year, the Administration issues two reports which detail the financial results for the Government. The ***President's Budget*** (Budget), the Government's primary financial planning and control tool, describes how the Government spent and plans to spend the money it collects. By comparison, the accrual-based ***Financial Report of the United States Government*** (Report) includes the cost of operations, the sources used to finance those costs, how much the Government owns and owes, and the outlook for its social insurance programs.

Table 1: Budget Deficit vs. Net Operating Cost

Dollars in billions	2008	2007
Budget Deficit	**$454.8**	**$162.8**
Change in:		
Federal Employee and Veteran Benefits Payable	$549.8	$90.1
Environmental & Disposal Liabilities	$0.8	$36.8
Capitalized Fixed Assets, Net	($46.6)	($2.6)
Other	$50.3	($11.6)
Net Operating Cost	**$1,009.1**	**$275.5**

In FY 2008, the Government incurred a record high unified budget deficit of $454.8 billion, more than doubling the FY 2007 deficit of $162.8 billion. This historic increase was due in great part to the combined effect of the developing weakness in the economy and the Government's response to that weakness. Because of the weakening economy, corporate tax revenues declined by $68 billion. These factors also contributed to the increase in the Government's net operating cost, which jumped to just over $1 trillion – more than three times the 2007 net operating cost of $275.5 billion. Net operating cost also increased due to agencies' substantial reestimates of liabilities for postemployment benefits. The Departments of Defense, Health and Human Services, and Veterans' Affairs, and the Social Security Administration, as well as interest on the Federal debt accounted for the majority of the Government's net costs. Table 1 shows that $549.8 billion changes in estimates of the Government's net postemployment liabilities to its military and civil service employees accounts for most of the difference between the Government's unified budget deficit and net operating cost. This issue is discussed further in the 'Where We Are' section of this document.

The Economy in Fiscal Year 2008

A review of the Nation's key economic indicators can add context to a discussion of the Government's financial results. As summarized in Table 2, the U.S. economy slowed noticeably in FY 2008, and it fell into recession in December 2007, three months into the fiscal year. Growth was significantly restrained for the third straight year by the ongoing slump in the residential homebuilding sector. In addition, consumer spending grew modestly during the first three quarters of the fiscal year, and then showed its sharpest one-quarter decline since 1980 in the final quarter. Record high energy prices through most of the year and elevated food prices dampened consumer confidence. Mounting financial market losses also weighed on confidence. The turmoil in the financial sector limited credit availability, further contributing to sagging consumption.

Table 2: Economic Indicators

National Economic Indicators	FY 2008	FY 2007
Real GDP growth	0.7%	2.8%
Residential construction growth	-20.9%	-17.0%
Average monthly payroll job increase (thousands)	-43	109
Unemployment rate (percent, end of period)	6.1%	4.7%
Consumer price index (CPI)	5.3%	2.4%
CPI, excluding food and energy	2.5%	2.1%
Treasury constant-maturity 10-year rate, (end of period)	3.9%	4.6%
Moody's Baa bond rate (end of period)	7.8%	6.6%

Employment fell beginning in January 2008, and the unemployment rate rose. Inflation was dominated by significant increases in energy and food prices, but underlying inflation remained relatively stable. Partly as a result of higher overall inflation, real wages fell throughout FY 2008 on a year over year basis. Corporate profits, outside the energy sector, weakened or declined. Federal tax receipts remained relatively constant and spending growth accelerated in FY 2008. As a result, the Federal unified budget deficit rose to $454.8 billion, or about 3.2 percent of GDP (compared to 1.2 percent in FY 2007).

After rising at an annual average rate of 2.8 percent during FY 2007, real GDP growth slowed to 0.7 percent over the four quarters of FY 2008. Quarterly performance was quite volatile. Growth was noticeably stronger in the third quarter of the fiscal year (2.8 percent), boosted in large part by a narrowing trade deficit and the spring stimulus payments, but real GDP declined 0.5 percent in the final quarter of the fiscal year. Residential fixed investment declined at double-digit rates in each of the fiscal year's four quarters, reflecting another year of sharply weaker housing demand. Nonresidential fixed investment growth slowed markedly during the fiscal year.

The following key points summarize economic performance in FY 2008.

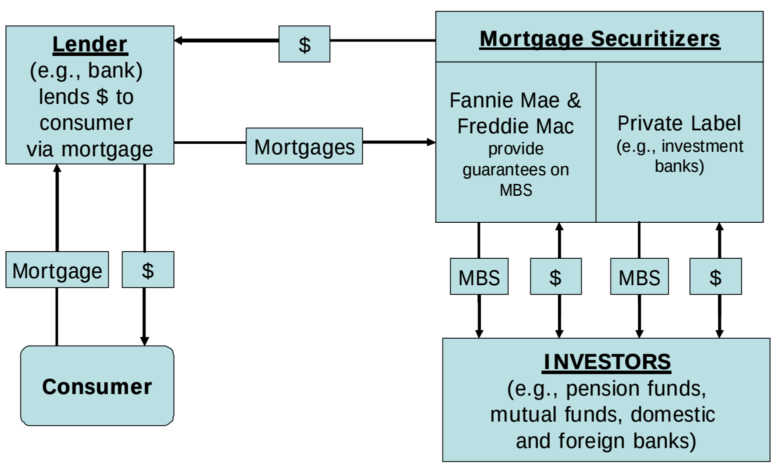
- After increasing by 2.7 percent in FY 2007, consumer spending was slightly negative over the four quarters of FY 2008, with a notable slowing in the final quarter.
- Exports have been a key driver of the economy, maintaining a steady pace of growth in FY 2008 and accelerating markedly during the latter half of the fiscal year, but the outlook for exports is uncertain in view of the spreading world-wide recession.
- Labor market conditions deteriorated during FY 2008. Nonfarm payroll employment declined at an average rate of 68,000 jobs per month in FY 2008, compared with the 109,000 average increase in jobs per month in FY 2007. From the employment trough of August 2003 through December 2007, the economy created 8.3 million new jobs, but between December and the end of FY 2008, employment fell by about 1 million.

- The unemployment rate trended steadily higher throughout FY 2008, reaching 6.1 percent at the very end of the fiscal year, compared to 4.7 percent at the end of FY 2007.
- Overall inflation, as measured by the consumer price index (CPI), advanced to 5.3 percent in FY 2008, up significantly from the 2.4 percent pace of FY 2007. Core inflation (which excludes food and energy) remained relatively contained, however, rising to 2.5 percent in FY 2008 versus 2.1 percent in FY 2007.
- Financial market turbulence intensified during the last few months of FY 2008, as uncertainties about the value of mortgage-market-related assets led investors to reappraise asset values in a variety of markets. This turbulence reduced credit availability. For example:
    - Corporate debt yields reached about 450 basis points above Treasury securities in late September 2008, compared with about 175 basis points in August 2007;
    - The difference between the 3-month London Interbank Offered Rate (LIBOR)[1] and the risk-free 3-month Treasury rate shot up to nearly 550 basis points in late September 2008 (after averaging less than 50 basis points in 2006 and much of 2007).

Market Stabilization Efforts

Volatility in the mortgage and credit markets during the last half of FY 2008 sparked unprecedented economic events. Efforts to restore financial stability began in earnest in March with the Federal Reserve's[2] support of JP Morgan Chase & Co. in its acquisition of The Bear Stearns Companies, Inc. (Bear Stearns). Bear Stearns had been considered one of the leading U.S. investment firms, with much of its investment portfolio tied to sub-prime mortgage-backed securities (MBS). Declines in the sub-prime credit market precipitated significant portfolio losses and a substantial cash shortfall not only at Bear Stearns, but eventually across many other major financial and credit institutions who had invested heavily in MBS in recent years. The MBS market played a key role in the deterioration of credit market conditions in FY 2008. Exhibit 2 provides an illustration of how individual mortgage loans are transformed into MBS.

Exhibit 2: Mortgage Securitization Process



MBS performance was directly dependent on the performance of the underlying mortgages and loans that comprised the security. A developing recession, housing market declines, including falling property values and demand, a decline in the value of the U.S. dollar, significantly increased availability and use of sub-prime loans (with limited homeowner equity), and increased mortgage defaults and foreclosures placed tremendous pressure on the MBS market, particularly the sub-prime portion of the market. Mounting losses compelled MBS investors, in particular bank investors, to retain whatever funds they could and minimize their exposure by being reluctant and, in some cases, refusing to make loans. This would ultimately lead to a 'frozen' credit market. Due to the inherent relationship between the MBS and the underlying loans, this freeze impacted a wide array of investors – from the prospective homebuyer seeking a mortgage on a first home, to the multimillion dollar corporation seeking short-term financing so that it could meet payroll. In addition, failing mortgage loans precipitated a surge in foreclosures.

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

[2] The Federal Reserve is the central banking system of the United States. It is a quasi-public (government entity with private components) banking system composed of (1) the presidentially appointed Board of Governors of the Federal Reserve System in Washington, D.C.; (2) the Federal Open Market Committee; (3) twelve regional Federal Reserve Banks located in major cities throughout the nation acting as fiscal agents for the U.S. Treasury; (4) numerous private U.S. member banks; and (5) various advisory councils. Since February 1, 2006, Ben Bernanke has served as the Chairman of the Board of Governors of the Federal Reserve System.

This precarious environment eventually led to the demise of such long-established firms as Lehman Brothers, and to transformations within or acquisitions of other major institutions, such as Wachovia Bank, Washington Mutual Bank, and American International Group (AIG). It also placed the financial future of both the Federal National Mortgage Association (Fannie Mae or Fannie) and the Federal Home Loan Mortgage Corporation (Freddie Mac or Freddie) in jeopardy. Something had to be done to restore investor and lender confidence and to get the credit pipeline flowing again. In response, the Treasury Department championed two legislative efforts in attempts to restore consumer confidence and market stability.

The Path to Recovery, Part I – HERA

In July 2008, Congress passed the Housing and Economic Recovery Act (HERA) of 2008, based on concern that continued losses at Fannie and Freddie and throughout the U.S. housing/credit market could lead to significantly larger and broader problems for both the U.S. and foreign economies. HERA established a new regulatory agency: the Federal Housing Finance Agency (FHFA) with enhanced regulatory authority over the housing Government Sponsored Enterprises (GSEs)[3], including the capital requirements and business activities of Fannie Mae and Freddie Mac. HERA also provided the Treasury Secretary with temporary authority to purchase any obligations and other securities issued by the housing GSEs.

Due to deteriorating conditions in the housing mortgage markets and the resulting negative financial impact on Fannie Mae and Freddie Mac, FHFA placed them under conservatorship on September 7, 2008. This action was taken to preserve GSE assets, ensure a sound and solvent financial condition, and mitigate systemic risks that contributed to current market instability. Placing Fannie Mae and Freddie Mac under protection of a conservatorship enabled the Government to avert the initial threat of failure and focus on the larger, systemic challenges, with the ultimate intention of restoring financial stability. Under the conservatorship, the conservator (FHFA) replaced the organization's senior management and oversaw the continued operation of the GSEs. Pursuant to the authorities provided to the Secretary of the Treasury under the HERA, the Treasury Department, on September 7, 2008, took three additional steps to help ensure the solvency and liquidity of the GSE while they are working to resolve their financial difficulties:

- entering into senior preferred stock purchase arrangements with Fannie Mae and Freddie Mac;
- establishing a GSE credit facility; and
- establishing a GSE MBS purchase program.

HERA established the HOPE for Homeowners Program[4], which provides another stop-gap measure by helping borrowers faced with foreclosure refinance through the Federal Housing Administration. Despite these actions, there was still a pressing need to address the more systemic challenges posed by the credit crisis.

The Path to Recovery, Part II – EESA and TARP

In October 2008, Congress passed and the President signed the Emergency Economic Stabilization Act (EESA), which authorized Treasury to establish and manage the Troubled Asset Relief Program (TARP). In general, TARP authorizes the Government to provide additional protection and stability to financial markets through a wide array of mechanisms:

- EESA authorizes the Government to purchase or insure up to $700 billion in troubled assets, such as securities and other financial instruments.
- The Treasury Secretary had immediate access to the first $250 billion. Following that, an additional $100 billion was authorized by the President. The last $350 billion is subject to Presidential approval and Congressional review. In its first use of the TARP, Treasury created the Capital Purchase Program (CPP) to purchase up to $250 billion in senior preferred shares in a wide variety of banks and other financial institutions. These will be largely non-voting shares, may be sold to a third party, and will pay a 5 percent dividend in the first 5 years, and 9 percent thereafter.

[3] The housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System) are chartered by the Federal Government and pursue a federally mandated mission to support housing finance. Some GSEs are distinctly established as corporate entities - owned by shareholders of stock traded on the New York Stock Exchange. The operations of the housing GSEs are not guaranteed by the Federal Government.

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

- Any firm participating in the CPP will provide the Treasury Secretary with a warrant guaranteeing the right to purchase additional common shares worth up to 15 percent of the value of the preferred stock purchased. The purchase price will be the average stock selling price over the 20-day period before the preferred stock purchase. If the company is unable to issue a warrant, it may issue senior debt instead.
- EESA provides for: (1) oversight by the Government Accountability Office (GAO) and a Special Inspector General; and (2) transparency by requiring Treasury to make available an electronic description of assets acquired under the program.

Recovery Efforts and Actions

The following summarizes some of the recovery efforts to date and their impact on and implications for the Government's consolidated financial statements. It should be noted that, although HERA and EESA authorize the Government to spend hundreds of billions of dollars in the recovery effort, the majority of those funds have yet to actually be spent, and as a result, are not and would not be reported on the Government's consolidated financial statements. Generally, the Government has recorded the funds that have already been spent at cost. The Government expects to recover, if not earn a return on these funds.

<u>Actions by Congress:</u>

- Passes HERA, which enhanced the regulatory framework and provided temporary authority for the Treasury Secretary to provide financial support to Government Sponsored Enterprises (GSEs).
- Passes EESA, establishing the Troubled Asset Relief Program (TARP), authorizing the Treasury Department to use up to $700 billion in support of market stabilization efforts. The $700 billion limit shall be reduced by the difference between outstanding and guaranteed obligations under the EESA-authorized insurance program, if any, and the balance in the Troubled Assets Insurance Financing Fund (TAIFF), established by EESA to guarantee timely payments on mortgage-related assets.
- Legislation only authorizes the Government to engage in specified market relief efforts. Authorizations by themselves do not impact either the Government's financial statements or the deficit - the exercise of those authorities do.

<u>Actions by the Federal Reserve System (Fed)</u>

- Lends approximately $30 billion in support of JP Morgan Chase to facilitate its acquisition of Bear Stearns;
- Agrees to lend up to $85 billion to American International Group (AIG). Subsequent to FY-end 2008, the credit facility was modified and Treasury agreed to purchase $40 billion in Senior AIG preferred stock and will receive common stock warrants for 2 percent of the outstanding AIG common stock;
- Announces Money Market Investor Funding Facility through which the Fed is authorized to buy $600 billion in CDs and commercial paper to bolster money market mutual funds, and sets up separate facilities to purchase certain AIG assets;
- Agrees to guarantee $306 billion of Citigroup troubled assets. Pursuant to the agreement, Citigroup would cover the first $37 billion in losses, Treasury would cover the next $5 billion, and FDIC would cover up to $10 billion of additional losses. Treasury and FDIC receive Citigroup preferred stock as part of the arrangement;
- Announces program to purchase up to $500 billion of mortgage-backed securities and up to $100 billion of Fannie and Freddie debt, and to lend up to $200 billion against new car, student, and small-business loans. Treasury has pledged $20 billion from TARP for this program as well;
- Under the Supplementary Financing Program, Treasury borrowed $300 billion to increase cash balances at the Fed to support the Fed's market stabilization efforts.

The vast majority of Fed actions and transactions will not directly impact the Government's financial statements since the Fed is an independent entity and, while part of the Government, is not considered part of the Federal Government reporting entity. To date, the Government's exposure is largely limited to any impact that losses from these programs may have on excess profits that the Fed is required to pass on to the Treasury's General fund.

<u>Actions by Treasury:</u>

- Under HERA authority, received preferred stock and warrants, valued at $7 billion as consideration for entering into assistance agreements - recorded as an investment. Commits to provide up to $200 billion under a preferred stock purchase agreement to ensure that GSEs' assets and liabilities remain in balance – records $13.8 billion as a liability in FY 2008, based upon the Federal Housing Finance Agency's notification to the Treasury Department that a payment is due to Freddie

Mac, based on Freddie Mac's September 30, 2008 net worth status. Fannie Mae did not require a payment in FY 2008. Purchased $3.3 billion in MBS and recorded that amount as a loan receivable in FY 2008.

- Under EESA, used over $200 billion to purchase assets of qualifying financial institutions since fiscal year-end as of December 9, 2008. None of these purchases occurred during FY 2008.

Amounts expended under HERA and EESA have been and are expected to be treated as either investments or loans, as the Government may recover and possibly even earn a positive return on amounts invested as economic conditions improve.

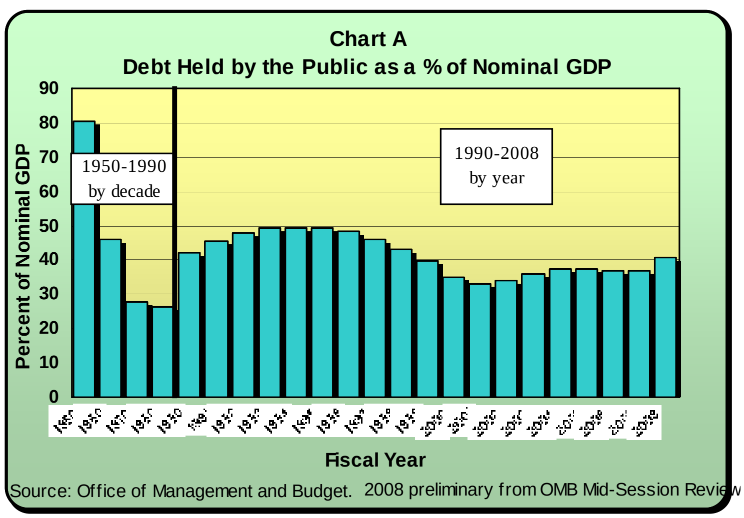
As the first quarter of FY 2009 draws to a close, the Government is exploring a number of other recovery strategies. Actions under HERA, EESA, and other initiatives are intended to restore confidence to lenders and consumers, and provide stability to the nation's economy.

Federal Debt

As noted earlier, the unified budget surplus or deficit is the difference between total Federal spending and receipts (e.g., taxes) in a given year. The Government borrows from the public (increases Federal debt levels) to finance deficits. During a budget surplus (receipts exceed spending), the Government typically uses those excess funds to reduce the debt borrowed from the public. Historically, the Government has incurred debt when: (1) it borrows from the public to fund budget deficits, and (2) government funds invest excess receipts in government securities. However, in FY 2008, this relationship changed, with Treasury borrowing over $300 billion to increase cash balances at the Fed so that the Fed can assist with market stabilization efforts. The implementation of both HERA and EESA including the Troubled Asset Relief Program (TARP) have the potential to increase future borrowings by more than $1 trillion. Substantial borrowings in FY 2009 and beyond are expected to fund stock and asset purchases at financial institutions across the country.

At the end of FY 2008, the Government had incurred $10 trillion in debt, comprised of: debt held by (or owed to) the public (i.e., publicly held debt) and intragovernmental debt (i.e., debt the Government owes to itself). Publicly held debt (a balance sheet liability) includes all Treasury securities (e.g., bills, notes, and bonds) held by individuals, corporations, Federal Reserve banks, foreign governments, and other entities outside the Government. Intra-governmental debt is primarily held in the form of special nonmarketable securities by various parts of the Government. Laws establishing Government trust funds generally require excess trust fund receipts to be invested in these special securities. Intra-governmental debt is not shown on the balance sheet because claims of one part of the Government against another are eliminated for consolidation purposes (see Financial Statement Note 11).

Gross Federal debt (with some adjustments) is subject to a statutory ceiling (i.e., the debt limit). Prior to 1917, the Congress approved each debt issuance. In 1917, to facilitate planning in World War I, Congress established a dollar ceiling for Federal borrowing, which has been periodically increased over the years (most recently from $9.8 trillion to $10.6 trillion in 2008). At the end of FY 2008, the amount of debt subject to the limit was $9.96 trillion, $655.2 billion under the limit. In October 2008, in connection with the passage of EESA, the limit was raised again to $11.3 trillion.



Publicly Held Debt as a Percentage of GDP

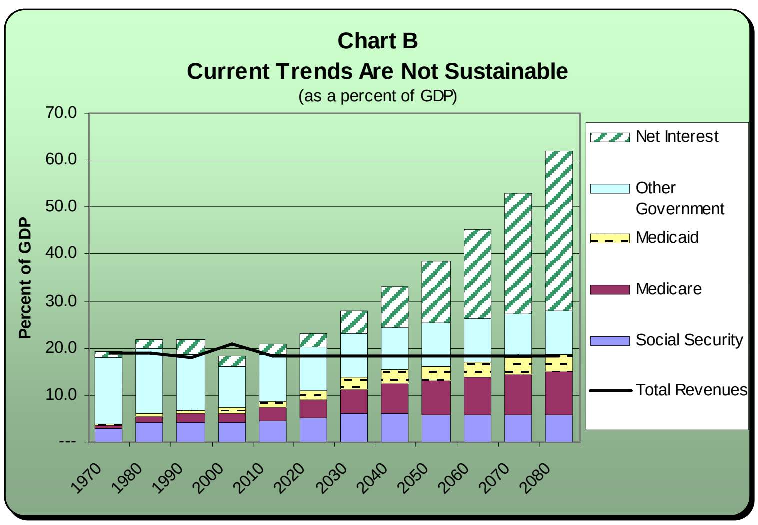
The Federal debt held by the public as a share of GDP (Chart A – on the previous page) compares a country's debt level to the size of its economy over time. In the late 1970s, increasing budget deficits spurred an increase in publicly held debt, which essentially doubled as a share of GDP over a 15-year period, reaching about 50 percent in

1993. The budget controls instituted by the Congress and the President, together with economic growth, contributed to declining deficits and emerging surpluses at the end of the 1990s. This improved fiscal performance led to a decline in publicly held debt, (from 43 percent of GDP to about 33 percent from 1998 through 2001). In fiscal years 2002 through 2004, the debt-to-GDP ratio started to rise slightly, due to many factors, including increased spending for homeland security and defense commitments, a decline in receipts owing to the recession and lower stock market value, tax cuts, and the expiration of the budget controls from the late 1990s. The publicly held debt-to-GDP ratio has ranged from 35 to 37 percent for most of this decade. The 2008 ratio of 40.8 percent is the highest since 1999, but is still far below the nearly 50 percent ratio of the mid-1990s.

The Long-Term Fiscal Outlook

While the Government's immediate priority is market stabilization and addressing the recession, it cannot lose sight of the longer term challenges. The Government's long-term financial condition will also depend on a number of factors, including: the market stabilization effort, the aging of the population and the growth rate of future health care costs. Consider the following:

- The 78 million baby boomers (those born between 1946 and 1964) comprise one quarter of the Nation's population. Beginning in 2008, the first of the 'boomers' became eligible for early retirement benefits under Social Security, and in 2011, they will start to become eligible for Medicare.
- Over the next 25 years, the share of the population aged 65 and older is forecast to *increase* from 12 percent to 20 percent (effectively increasing anticipated expenditures), while the share of the Nation's population that is working and paying taxes (anticipated revenue) will *decrease* from 60 percent to approximately 55 percent.
- Medicare spending has grown at more than 1½ times the overall rate of economic growth over the last four decades, and the Medicare Trustees assume that Medicare expenditures will continue to outpace overall economic growth in the future.
- Social Security, Medicare, and Medicaid expenditures are projected to grow from 44 percent of Government non-interest expenditures to 65 percent by 2030.
- Under current law, 30 years from now, Government revenues will be sufficient to cover approximately half of all anticipated expenditures.



- Chart B shows, as a percent of GDP, the Government's: (1) historical and assumed revenues (at 18 percent); (2) historical and projected long-term expenditures for Social Security, Medicare, Medicaid, interest on the debt held by the public, and other purposes, and (3) the difference between the two.[5]

The assumed constant revenue-to-GDP ratio of about 18 percent is based on an average historical ratio of 18 percent over the past several decades. Chart B also shows that, by 2080, expenditures on just three programs (Social Security, Medicare, and Medicaid) could absorb all Government revenue.

Without a change in law, by 2060, total Government expenditures are projected to be 45 percent of GDP–levels unseen since World War II, when Government expenditures reached a record high of 44 percent of GDP.

[5] In this chart, expenditures for Social Security and Medicare are consistent with the SOSI, expenditures for Medicaid reflect Medicare cost growth rates and Social Security demographic projections, and expenditures for all other programs and tax revenue are assumed to grow at the same rate of growth as GDP. Supplemental appropriations are assumed to be phased out over the next ten years.

And by 2080, expenditures could exceed 60 percent of GDP. Such a dramatic increase in spending and, as explained below, necessary Government borrowing is not sustainable.

Much uncertainty surrounds the future of Government programs and their impact on Government finances. Despite this uncertainty, projections such as these are critical to assessing whether future Government revenue will be sufficient to meet future expenses.

Social Insurance Trust Funds

Social Security:

- Old-Age and Survivors Insurance (OASI) pays retirement and survivors benefits,
- Disability Insurance (DI) pays disability benefits.

Medicare:

- Part A: Hospital Insurance (HI), which pays for inpatient hospital and related care.
- Part B: Supplementary Medical Insurance (SMI), which pays for physician and outpatient services
- Part D, SMI prescription drug benefit program.

Social Insurance

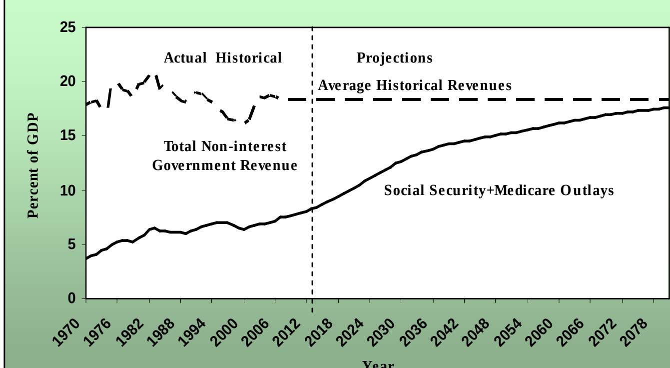
For the 'social insurance' programs -- Social Security, Medicare, Railroad Retirement, and the Black Lung Program - the Statement of Social Insurance (SOSI) reports: (1) the actuarial present value of: all future program revenue (mainly taxes and premiums) - excluding interest - to be received from or on behalf of current and future participants; (2) the estimated future scheduled expenditures to be paid to or on behalf of current and future participants; and (3) the difference between (1) and (2). Amounts reported in the SOSI and in the supplemental information in this report are based on each program's official actuarial calculations.

Table 3: Social Insurance Future Expenditures in Excess of Future Revenues

	2008	2007	Increase (Decrease) $	%
Closed Group (Net):				
Social Security	$ 17,188	$ 16,265	$ 923	5.7%
Medicare:			$ -	
Part A	$ 13,590	$ 12,044	$ 1,546	12.8%
Part B	$ 12,615	$ 10,347	$ 2,268	21.9%
Part D	$ 5,605	$ 6,273	$ (668)	-10.6%
Subtotal - Medicare	$ 31,810	$ 28,664	$ 3,146	11.0%
Other	$ 137	$ 133	$ 4	2.7%
Total Social Insurance Expenditures, Net (Closed Group)	$ 49,135	$ 45,062	$ 4,073	4.9%
Total Net Social Insurance Expenditures, Net (Open Group)	$ 42,970	$ 40,948	$ 2,023	4.9%

The SOSI provides additional perspective on the Government's long term estimated exposures and costs. However, it should be noted that the Government's financial statements do not reflect future costs implied by any current policy, such as national defense, the global war on terrorism, and disaster relief and recovery. Table 3 shows the Government's estimated present value of future social insurance expenditures, net of dedicated future revenues for the programs reported in the Statement of Social Insurance (SOSI), projected to be $43 trillion as of January 1, 2008 for the 'Open Group'[6]. While these expenditures are currently not considered Government liabilities, they do have the potential to become liabilities in the future, based on the continuation of the social insurance programs' provisions contained in current law.

Chart C
Total Government Noninterest Revenue and Social Security and Medicare Outlays
(percent of GDP)



Historical data are from 2008 Analytical Perspectives based on fiscal year data.
Social Security and Medicare projections from the 2008 Trustees Reports based on calendar year data.

The social insurance trust funds account for all related program income and expenses. Social Security and Medicare 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 (surpluses) 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.

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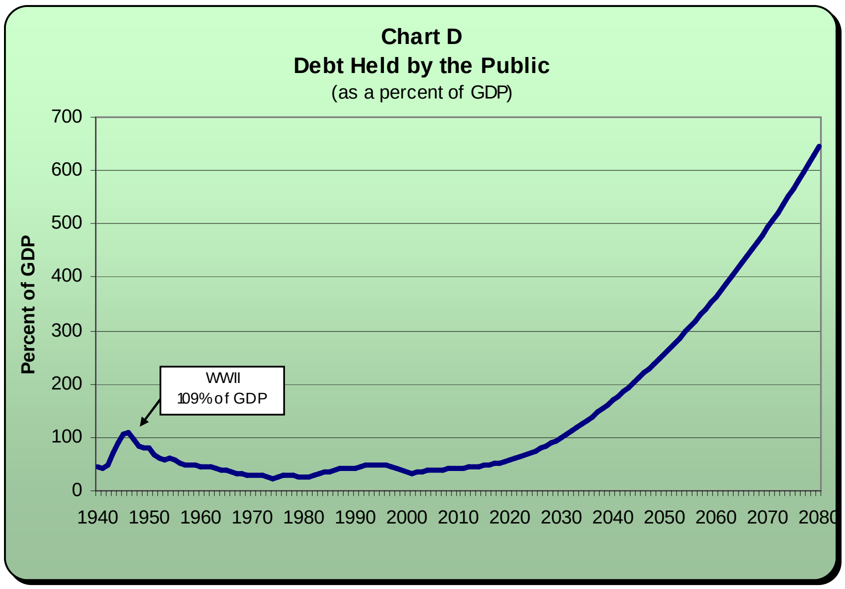
[6] 'Closed' Group and 'Open' Group differ by the population included in each calculation. From the SOSI, the 'Closed' Group includes: (1) participants who have attained eligibility and (2) participants who have not attained eligibility. The 'Open' Group adds future participants to 'Closed' Group. See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

As shown in Chart C, over the next two decades, Medicare and Social Security expenditures are projected to increase from their current 8 percent of GDP to about 11 percent. By 2080, they are projected to be approaching the 18 percent of GDP assumed for all revenues[7]. Simply said, holding total revenues constant, current spending for Social Security and Medicare alone will put unsustainable pressure on limited Government resources.

Unsustainable Debt

As noted earlier, the Government must borrow from the public to finance any gaps between expenditures and revenues. Increased borrowing leads to higher levels of debt and debt service (net interest) which in turn can make it more difficult to balance expenditures and revenues in the future. Chart D shows that by 2017, publicly held debt is projected to rise to 50 percent of GDP, surpassing the non-wartime peak of 49 percent in 1993. Without changes to the major three entitlement programs, publicly held debt may be more than 110 percent of GDP by 2032, surpassing the World War II peak of 109 percent, and by 2080, publicly held debt may exceed 600 percent of GDP.



Such rapid growth in the Government's deficit and resulting debt would create financial sector instability, increasing risk and uncertainty across many sectors of the U.S. economy. Avoiding the economic consequences of this fiscal path will require action to bring program expenditures and Government resources in balance. Delays in addressing this critical issue could increase the magnitude of the changes needed and place a greater burden on future generations.

The Government has made and is expected to continue to make a vast commitment of financial resources to establish and maintain stability in the credit markets, although many of the financial assets acquired by the Government in its market stabilization efforts may eventually be sold and return value to the taxpayer. The Government has been able to take these stabilization actions because investors believe the United States' credit is unimpeachable, prompting investors to willingly purchase Treasury securities in preference to other securities. The unsustainable growth in Social Security, Medicare, and Medicaid remains a long-term fiscal challenge to be addressed once the current credit crisis has passed and overall economic conditions have improved.

[7] The Medicare Trustees' Report shows that, under current law, the Hospital Insurance Trust Fund will not have sufficient funds to pay scheduled benefits beginning in 2019. At that point, trust fund income would cover only 78 percent of scheduled benefits, falling to about 30 percent in 2082. The Social Security Trust Fund could encounter a similar problem. Under current law, trust fund income would cover only 78 percent of scheduled benefits in 2041 and only 75 percent in 2082.

Financial Position and Results of Operations

This *Report* provides the results of the Government's financial operations, including its financial condition, revenues and costs, assets and liabilities, and other obligations and commitments. This information, when combined with the President's Budget, collectively provides a valuable tool for managing current operations and planning future initiatives.

Accrual-Based Results and Basis of Accounting

Each year, the Administration issues two reports that detail financial results for the Federal Government: the *President's Budget*, whose main purpose is to provide a prospective discussion of future initiatives and the resources needed to support them; 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 outlook for its social insurance programs.

President's Budget	Financial Report of the U.S. Government
Prepared primarily on a '*cash basis'* • Initiative-based: focus on current and future initiatives planned and how resources *will be used* to fund them. • Receipts ('cash in'), e.g. federal income tax received, National Park fees collected. • Outlays ('cash out'), e.g., defense spending, benefit checks sent.	Prepared on an '*accrual basis'* • Retrospective – prior and present resources used to implement initiatives. • Revenue: recognized when earned, but not necessarily received (with the exception of tax revenues - see footnote). • Costs: recognized when owed, but not necessarily paid.

Treasury prepares the financial statements in this Report on an 'accrual basis' of accounting as prescribed by U.S. generally accepted accounting principles (GAAP) for Federal entities.[8]

These standards are tailored to the Government's unique characteristics and circumstances. For example, agencies prepare a uniquely structured 'Statement of Net Cost,' which is intended to present net Government resources used in its operations, instead of an 'Income Statement,' which private sector companies typically use to focus on profits earned. Also unique to Government is the preparation of separate statements, to reconcile differences and articulate the relationship between budget and accrual accounting results (e.g., Statement of Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Deficit and the Statement of Changes in Cash Balance from Unified Budget Deficit and Other Activities).

Reporting Entity

These financial statements conceptually cover the three branches of the Government (legislative, executive, and judicial). Legislative and judicial branch reporting focuses primarily on budgetary activity. Only executive branch entities are required, by law, to prepare audited financial statements. Some legislative branch entities do, however, voluntarily submit financial reports.

A number of Government entities and organizations are excluded due to the nature of their operations, including the Federal Reserve System (an independent entity that serves both public and private purposes); the Federal Retirement Thrift Investment Board; all fiduciary funds, and government-sponsored but privately-owned enterprises, including the Federal Home Loan Banks, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. A list of the significant agencies and entities contributing to this report is included in the Appendices.

Limitations of the Financial Statements

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

Exhibit 3, on the following page is a blueprint to the Government's financial statements, demonstrating how they connect with one other.

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[8] Under GAAP, most U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable.

Exhibit 3
Navigating the Government's Financial Statements

I
Statements of Net Cost

(in billions)	2008	2007
Gross Cost	$ (3,891.6)	$ (3,157.3)
(-) Earned Revenue	250.9	247.8
(=) Net Cost [1]	**$ (3,640.7)**	**$ (2,909.5)**

How does Net Cost affect Net Position?

II
Statements of Operations and Changes in Net Position

(in billions)	2008	2007
Net Postion (beginning)	**(9,205.8)**	**(8,916.4)**
(+) Revenue	2,661.4	2,627.3
(-) Net Cost	(3,640.7)	(2,909.5)
Net Operating Cost	**(1,009.1)**	**(275.5)**
(=) Net Position (end)*	**$ (10,203.5)**	**$ (9,205.8)**

*Includes the effect of prior period adjustments.

*Net Operating Cost includes adjustment for Unmatched Transactions and Balances.

How does Net Operating Cost differ from the Budget Deficit?

IV
Statements of Changes in Cash Balance from Unified Budget Deficit and Other Activities[5]

(in billions)	2008	2007
Budget Surplus (Deficit) [4]	**(454.8)**	**(162.8)**
Cash and Other Monetary Assets:		
Beginning Balance	128.0	97.9
(+) Increase (Decrease) in cash and other monetary assets	296.5	30.1
(=) Ending Balance	**$ 424.5**	**$ 128.0**

How did the Government's cash change?

III
Reconciliation of Net Operating Revenue (or Cost) & Unified Budget Surplus (Deficit)

(in billions)	2008	2007
Net Operating Cost [2]	**(1,009.1)**	**(275.5)**
Increase (Decrease) in :		
Postemployment Liabilities	549.8	90.1
Environmental Liabilities,	0.8	36.8
Other, Net	3.7	(14.1)
Unified Budget Surplus (Deficit) [4]	**$ (454.8)**	**$ (162.8)**

V
Balance Sheet

(in billions)	2008	2007
Assets:		
Cash [5]	$ 424.5	$ 128.0
Property, Plant & Equipment	737.7	691.1
Inventories & Related Property	289.6	277.1
Loans Receivable	263.4	231.9
Other	259.5	253.0
Total Assets	**1974.7**	**1581.1**
Liabilities:		
Debt held by the Public	5,836.2	5,077.7
Federal Employee and Veteran Benefits	5,318.9	4,769.1
Environmental Liabilities	342.8	342.0
Other	680.3	598.1
(-) Total Liabilities	**$ (12,178.2)**	**$ (10,786.9)**
Net Position [3]	**$ (10,203.5)**	**$ (9,205.8)**

What does the Govt own?

What does the Govt owe?

Net Position also shown in II

What about Social Security and Medicare?

VI
Statement of Social Insurance (SOSI)*

Present Value of Future Expenditures in Excess of Future Revenues

	2008	2007
Social Security	$ (6,555)	$ (6,763)
Medicare	$ (36,312)	$ (34,085)

*Note - The SOSI presents the projected actuarial estimates of future expenditures, net of contributions over a 75-year period. SOSI amounts illustrate the long-term financial sustainability of the social insurance programs, and are therefore NOT reflected in the balance sheet or other financial statements. Amounts reflect 'open group' totals.

1. The Statements of Net Cost presents the Government's net operating expense, which, when combined with tax and other revenue in the Statement of Operations and Changes in Net Position, yields the Government's Net Operating Cost and shows how the Government's Net Position changed during the year.

2 The Net Position from the Statement of Operations and Changes in Net Position agrees to the Net Position on the Balance Sheet, which is based on the difference between the Government's reported assets and liabilities.

3. The 'Reconciliation Statement' shows the primary differences between the Government's accrual-based Net Operating Cost and cash-based unified budget deficit.

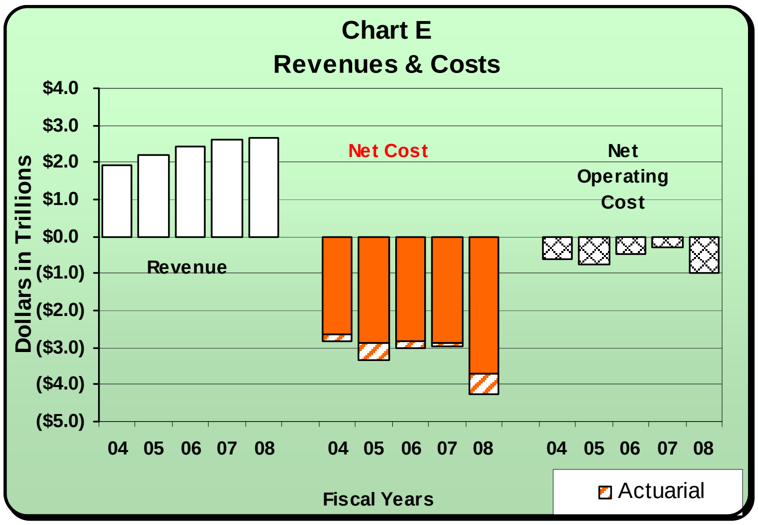
4 The Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit) shows the differences between the Government's spending deficit and its Net Operating Cost.

5 The Statement of Changes in Cash Balance from Unified Budget and Other Activities explains why the unified budget deficit normally would not result in an equivalent change in teh Government's Cash and Monetary Assets. The ending balance of Cash and Other Monetary Assets on this statement is the same as it is on the Balance Sheet.

Determining the Government's Net Position: "Where We Are"

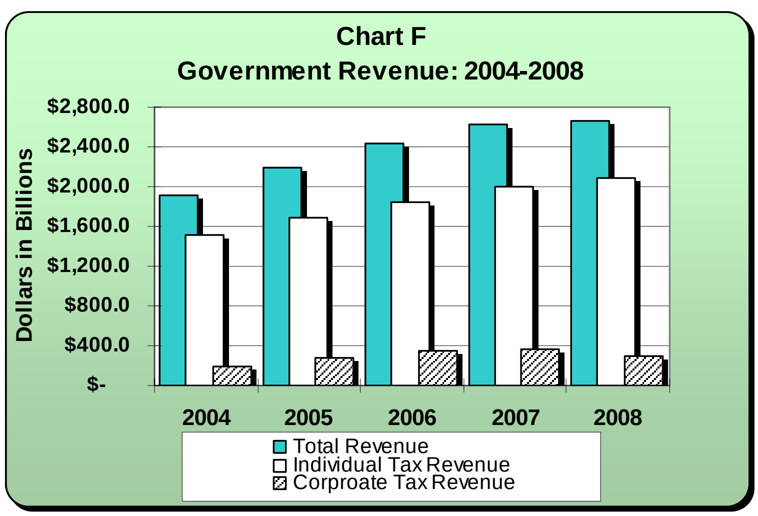
The Government's financial position and condition have traditionally been expressed through the Budget, focusing on the impact of surpluses and deficits. However, this primarily cash-based discussion of the Government's net outlays (deficit) or net receipts (surplus) tells only part of the story. The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

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



The Government's ***Statement of Operations and Changes in Net Position***, much like a corporation's income statement, shows the Government's 'bottom line'. Chart E shows that the Government has incurred a total net operating cost (i.e., costs have exceeded its revenues) over the past several years. Notably, in FY 2008, net operating costs exceeded $1 trillion for the first time (Chart E). The Government's revenues last exceeded its costs in FYs 1999 and 2000 in concert with the budget surplus.

The Government nets its costs against both earned revenues from Government programs (e.g., national park entry fees) and taxes, which account for the vast majority of total revenues. In addition, the Government distinguishes revenues that are earmarked for specific purposes (e.g., Medicare premiums) from those for general purpose spending. The Government's 'bottom line' is its net operating cost, or total costs in excess of revenues. The Government must issue debt to finance any costs as they are paid that cannot be covered by revenues, subject to the statutory debt limit.



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 cash-based budget deficit. Most of this difference is attributable to accruals of actuarial costs associated with the estimated present value of the Federal Government's net postemployment liabilities. Chart E shows the effect of this 'actuarial' element on the Government's total net cost. These actuarial costs, in recent years, have also accounted for majority of the change in the annual change in the Government's total net cots. The Department of Veterans Affairs (VA) and other agencies use a number of assumptions, such as interest rates and life expectancy, to make annual actuarial projections of their long-term benefits liabilities and the related costs. As further discussed later, changes in these assumptions can cause those projections, and consequently total costs, to fluctuate, sometimes significantly, year to year.

Revenue: "What Came In"

The ***Statement of Net Costs*** reports 'earned' revenue generated by Federal programs. In FY 2008, more than 25 percent of these revenues were attributable to Medicare premiums paid by program participants. The ***Statement of Operations and Changes in Net Position*** shows the Government's taxes and other revenues (i.e., revenues other than 'earned'). Government revenue totaled $2.7 trillion, remaining relatively constant and increasing slightly by $34 billion or just over 1 percent, compared to FY 2007. Individual income tax revenue increased by $79 billion or almost 4 percent. However, the developing recession precipitated a significant decline in corporate tax revenues ($67.5 billion or more than 18 percent). Individual and corporate tax revenue account for the majority (nearly 90 percent) of total revenues (see Chart F).

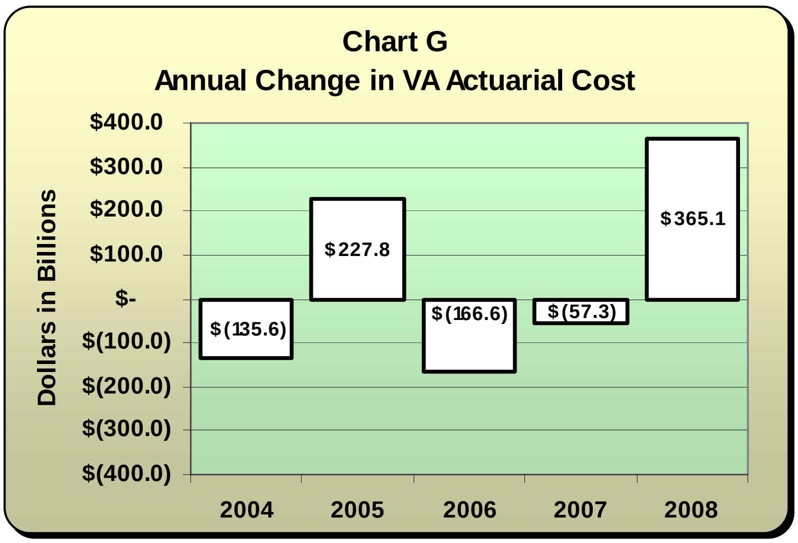
Table 4: Gross Cost. Revenues, and Net Cost

Dollars in Billions	2008	2007	Increase $	Increase %
Gross Cost				
DoD	$ (767.6)	$ (689.6)	$ (78.0)	11.3%
HHS	$ (769.1)	$ (718.6)	$ (50.5)	7.0%
SSA	$ (663.9)	$ (626.4)	$ (37.5)	6.0%
VA	$ (434.6)	$ (63.1)	$ (371.5)	588.7%
Interest on Federal Debt	$ (241.6)	$ (238.9)	$ (2.7)	1.1%
Other Federal Agencies	$ (1,014.8)	$ (820.7)	$ (194.1)	23.6%
Total Gross Cost	**($3,891.6)**	**($3,157.3)**	**$ (734.3)**	**18.9%**
Less: Earned Revenue	$250.9	$247.8	$ 3.1	1.2%
Net Cost	**($3,640.7)**	**($2,909.5)**	**$ (731.2)**	**25.1%**
Less: Taxes & Other Revenue	$ 2,661.4	$ 2,627.3	$ 34.1	1.3%
Net Operating Cost [1]	**($1,009.1)**	**($275.5)**	**$ (733.6)**	**266.3%**

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

Cost: "What Went Out"

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



In FY 2008, the Government's 'bottom line' net operating cost totaled $1,009.1 billion or just over $1 trillion, a substantial increase over FY 2007's net operating cost of $275.5 billion (see Table 4). As noted earlier, changes in the actuarial calculations of VA's veterans benefit liability were the primary reason behind a nearly seven-fold increase in VA's actuarial and gross costs during FY 2008, compared with a relatively meager decrease in FY 2007 (see Chart G). Table 5 shows the major components of this significant liability change, which include changes in discount rates, pay adjustments, and estimates of veteran eligibility. The liability increase of $339 billion in FY 2008, when compared to a $26 billion decrease in FY 2007, combine to cause a $365 billion increase in actuarial cost for FY 2008. This was the largest increase by far at VA in recent years and accounted for: (1) approximately 98 percent of the increase in VA total net costs, and (2) about half of the increase in total net cost across the Government. DoD also experienced a significant increase ($110 billion) due to reestimation of its net postemployment benefit liabilities.

Table 5

Components of VA Federal Employee & Veteran Benefit Liability Change - FY 2008

Dollars in billions	$	%
Changes in discount rates	128	38%
Changes in original awards	106	31%
Change in report date	60	18%
Other sources	45	13%
Total Change	**339**	**100%**

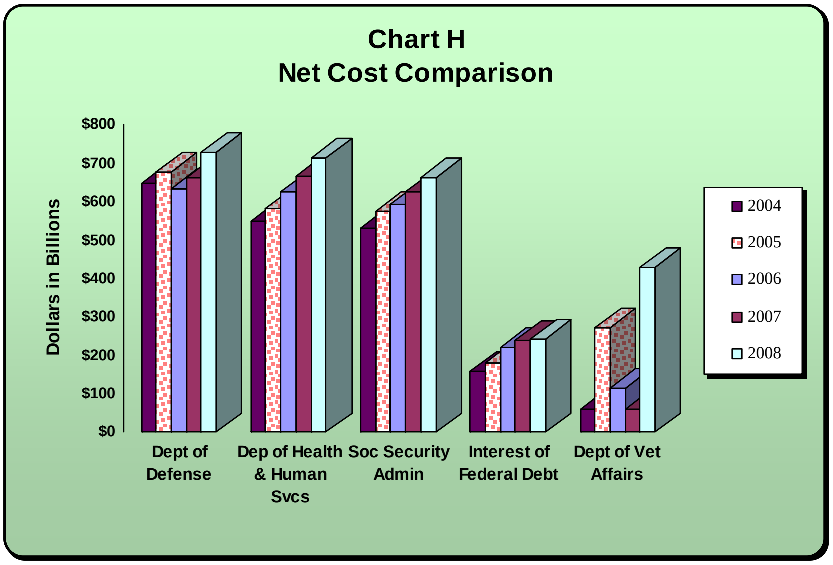


Chart H shows that DoD, HHS, and SSA have consistently incurred the largest agency shares of the Government's total net cost of operations in recent years. HHS and SSA combine to make up about 40 percent of the 2008 total net cost of operations, the bulk of which are attributable to these agencies' administration of the Government's major social insurance programs, e.g., Social Security and Medicare. The ***Statement of Social Insurance*** (SOSI) and the related information in this report discuss the current costs and future sustainability of these programs in greater detail. Of note, the substantial cost increase from VA's revaluation of net postemployment liabilities increased the Department's proportional share of total net costs from 2 percent in FY 2007 to 12 percent in FY 2008. Among cabinet agencies, the Energy Department experienced the greatest cost decrease (50 percent). Energy also attributes the majority of this decrease to revaluations of unfunded liability estimates, caused primarily by a 1.25 percentage point increase in the discount rate and smaller than expected pension plan values.

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

Net Position at the end of the year can also be derived by netting the Government's assets against its liabilities, as presented in the ***Balance Sheet***. It is important to note that the balance sheet does not include the financial value of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. As noted earlier, the Government distinguishes between resources and spending that are earmarked for specific purposes versus those intended for general purposes. In FY 2008, earmarked funds accounted for less than 6 percent of the Government's total Net Position. In addition, as was the case with the ***Statement of Operations and Changes in Net Position***, the ***Balance Sheet*** does include a separate presentation of the portion of net position earmarked for specific funds and programs (e.g., Social Security, Medicare, unemployment, and military and civilian retirement). Moreover, the Government's exposures are broader than the liabilities presented on the balance sheet, including such items as the Government's future social insurance exposures (e.g., Social Security and Medicare), as well as other commitments and contingencies. These exposures are discussed in this section as well as in the supplemental disclosures of this Report.

Table 6: Assets and Liabilities

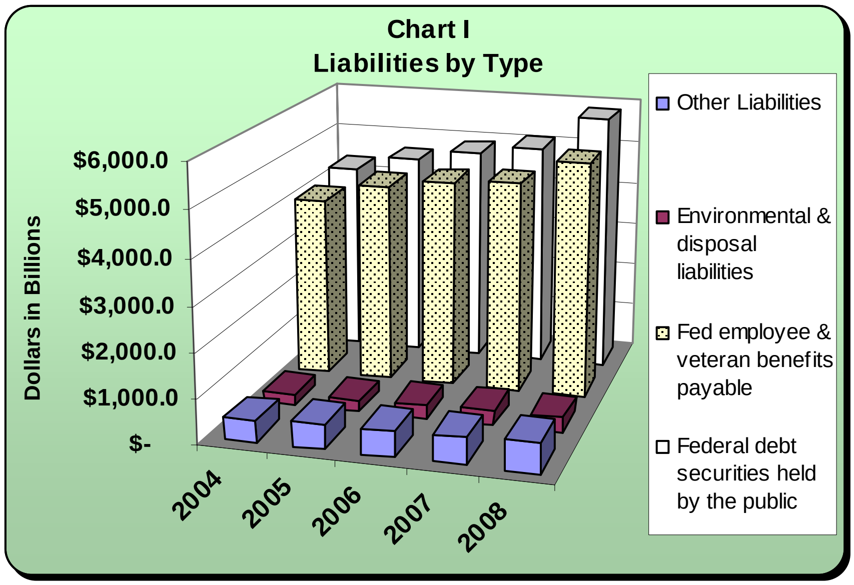
Net Position Dollars in Billions	**2008**	**2007**	Increase (Decrease) **$**	**%**
Assets	**$ 1,974.7**	**$ 1,581.1**	$ 393.6	24.9%
Less: Liabilities, comprised of:				
Debt Held by the Public	$ 5,836.2	$ 5,077.7	$ 758.5	14.9%
Federal Employee & Veterans Benefits	$ 5,318.9	$ 4,769.1	$ 549.8	11.5%
Other Liabilities	$ 1,023.1	$ 940.1	$ 83.0	8.8%
Total Liabilities	**$ 12,178.2**	**$ 10,786.9**	$ 1,391.3	12.9%
Net Position (Assets Minus Liabilities)	**$ (10,203.5)**	**$ (9,205.8)**	**$ (997.7)**	**-10.8%**

Assets – "What We Own"

During FY 2008, nearly all Government asset balances increased. Net property, plant, and equipment ($737.7 billion in FY 2008) has been the Government's largest asset over the past several fiscal years, accounting for approximately 40% percent of $1,974.7 billion in total assets in FY 2008 (see Table 6). As part of the market stabilization effort, the Government implemented the Supplementary Financing Program (SFP) - a temporary program that deposits cash in Treasury bank accounts with the Fed -- causing the Government's cash balance to rise by $300 billion as of September 30, 2008. This program also accounted for a corresponding $300 billion increase in publicly held debt. In addition to assets recorded on the balance sheet, the Government owns certain other stewardship assets such as land (e.g., national parks and forests) and heritage assets (e.g., national memorials and historic structures).

Liabilities – "What We Owe"

Chart I shows the major components of liabilities, or what the Government owes, as of September 30, for fiscal years 2004 through 2008. As indicated in Table 6, the largest liability in recent years has been Federal debt held by the public and accrued interest, the balance of which increased to $5,836.2 billion in FY 2008. The increase in expenditures resulted in the Government having to borrow additional cash from the public this year. In addition, as noted above, implementation of the temporary SFP resulted in the issuance of hundreds of billions of dollars in new debt. Over the past seven fiscal years, Federal debt securities held by the public and accrued interest have moved in tandem with the budget results. ***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, and explains how a budget surplus or deficit normally affects changes in debt balances.



The Government's net borrowings from the public, including accrued interest, increased by $758.5 billion in FY 2008. Typically, budget surpluses have resulted in borrowing reductions, and budget deficits have yielded borrowing increases. However, the Government's debt operations are much more complex than this would imply. Each year, trillions of dollars of debt matures and new debt takes its place. In FY 2008, new borrowings were $5.6 trillion and maturing debts repaid were $4.9 trillion. As noted earlier, market stabilization efforts could further impact net borrowings as the Government will likely need to issue debt to continue to fund financial asset purchases and support the capital needs of the banking industry.

Federal employee postemployment and veteran benefits payable have increased dramatically in recent years, to $5,318.9 billion as of fiscal year-end 2008 (representing nearly half of the Government's total liabilities), with civilian benefits payable accounting for more than a third of total employee and veteran benefits. The Office of Personnel Management (OPM) administers the largest civilian pension plan, covering nearly 2 million current employees and 2.4 million annuitants[9]. The military pension plan covers nearly 3 million current employees (including active service, reserve, and national guard) and approximately 2.2 million annuitants[10]. Environmental and disposal liabilities stayed relatively constant at approximately $343 billion as of September 30, 2008. The majority of these types of liabilities are attributable to the Departments of Defense and Energy for the clean-up of radioactive waste and other nuclear material stored at former testing and storage sites.

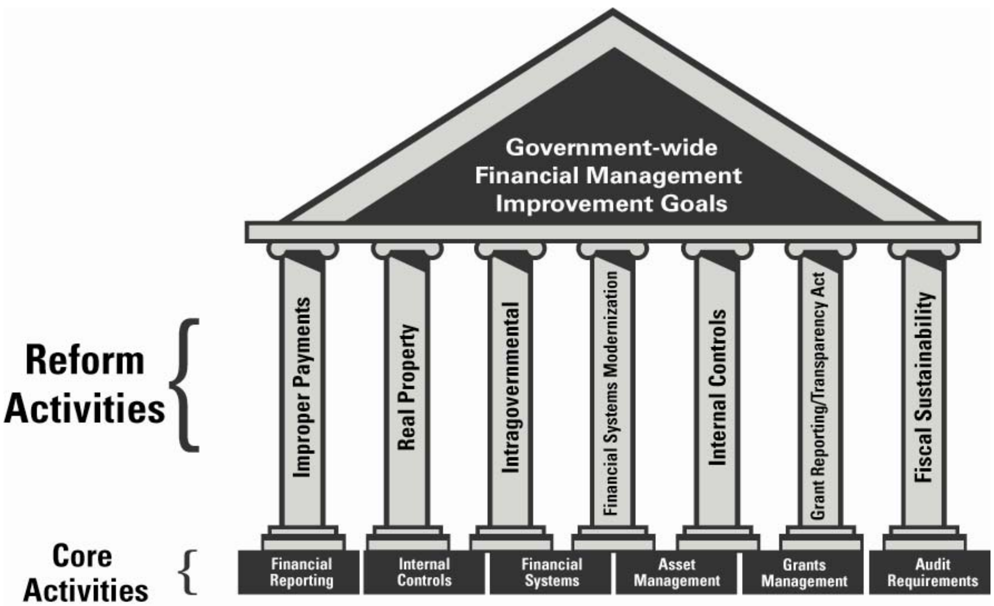
[9] OPM FY 2008 Performance and Accountability Report, p. 1.

[10] DoD FY 2008 Military Retirement Fund (MRF) financial statements, p 6.

How We Define and Measure Financial Management Success

The Office of Management and Budget (OMB) provides Federal agencies with a concise set of clear and measurable financial management performance goals that allow Federal managers, Congress, and the public to gauge whether taxpayer funds are being properly accounted for and wisely spent. These performance measures include, among others, the achievement of clean audit opinions, the elimination of material weaknesses in internal control, timely financial reporting, the disposal of excess real property, the elimination of improper payments, and the reduction in government costs through the strategic use of financial data. What follows is an overview of FY 2008 results for OMB's Government-wide initiatives: 1) Improving Financial Performance, 2) Eliminating Improper Payments, and 3) Real Property Asset Management.[11]

These initiatives are managed by OMB's Office of Federal Financial Management (OFFM). OFFM has also developed a "Framework for Improving Financial Performance" to provide direction and clarity on how these financial management improvement goals will be met. The Framework (as depicted in the below diagram) is intended to provide stakeholders with a simple tool for identifying the: 1) priority objectives of the Government's financial management improvement efforts, which historically have included improving financial statement audit results and other financial health metrics, such as reducing improper payments; 2) ongoing Government-wide financial management reform activities; and 3) day-to-day financial management activities or "core" activities that help ensure a strong foundation is in place for achieving financial management success.



The Framework is also described in OFFM's 2008 Federal Financial Management Report that was submitted to the Congress on January 31, 2008. The most recent reports are available at http://www.whitehouse.gov/omb/financial/reports. Also visit http://www.Results.gov and http://www.ExpectMore.gov for additional information on OMB's initiatives, including individual agencies' performance under these initiatives, and agencies' performance under their individual programs.[12]

11 The other four initiatives are: 1) Implementing Strategic Human Capital, 2) Gaining Efficiencies through Strategic Sourcing, 3) Expanding Electronic Government, and 4) Performance Improvement.

12 Since programs are not administered at the Government-wide level, the FASAB requirement to report performance goals and measures for the Federal Government as a whole does not apply and, therefore, is not reported upon here. Program administration and the subsequent reporting of the outcomes and results of those programs are handled at the agency level.

Fiscal Year 2008 Results

Improving Financial Performance

For the fourth year in a row, **all** major Federal agencies successfully met the 45-day financial audit deadline as required by the rigorous reporting guidelines set by OMB. Since 2004, agencies are required to complete the financial report 45-days after the end of the fiscal year, compared to the previous five month (150 days) window for completion. The accelerated deadline results in more immediate availability of financial information to agency decision-makers and requires agencies to employ rigorous disciplines throughout the year to ensure readiness for year-end reporting.

In addition to timely reporting, the results from FY 2008 show that the Federal Government is improving the validity of its financial information. Of the 24 major Federal agencies, 20 received clean opinions, one more than the 19 clean opinions reported last year and the highest total in the past 6 years. Table 7 below includes the audit results for FY 2008.

Table 7: Summary of FY 2008 Financial Statement Results by Agencies

CFO Act Agencies:	*FY 2008 Audit Opinion*
Department of Agriculture (USDA)	Unqualified
Department of Commerce (DOC)	Unqualified
Department of Defense (DOD)	Disclaimer
Department of Education (Education)	Unqualified
Department of Energy (DOE)	Unqualified
Department of Health and Human Services (HHS)	Unqualified
Department of Homeland Security (DHS)[13]	Disclaimer
Department of Housing and Urban Development (HUD)	Unqualified
Department of the Interior (DOI)	Unqualified
Department of Labor (DOL)	Unqualified
Department of Justice (DOJ)	Unqualified
Department of State (State)	Disclaimer
Department of Transportation (DOT)	Unqualified
Department of the Treasury (Treasury)	Unqualified
Department of Veterans Affairs (VA)	Unqualified
Agency for International Development (USAID)	Unqualified
Environmental Protection Agency (EPA)	Unqualified
General Services Administration (GSA)	Unqualified
National Aeronautics and Space Administration (NASA)	Disclaimer
National Science Foundation (NSF)	Unqualified
Nuclear Regulatory Commission (NRC)	Unqualified
Office of Personnel Management (OPM)	Unqualified
Small Business Administration (SBA)	Unqualified
Social Security Administration (SSA)	Unqualified

This year's Government-wide results are complemented by notable milestones for these individual agencies:

[13] Balance Sheet and Custodial Statement Audit Only

- **The U.S. Army Corps of Engineers (USACE).** USACE achieved its first ever clean audit opinion. The Army Corps is the largest organization within the Department of Defense (DoD) to achieve this milestone. This accomplishment is a critical building block for DoD's overarching effort to achieve a clean opinion.

- **The Department of the Treasury (Treasury).** As the Federal government took action to stabilize the economy, the Treasury faced the challenge of accounting for an unprecedented and complex array of financial activities that took place within a few days of the end of the fiscal year. The Treasury Department's achievement of a clean audit opinion this year demonstrates that it was equal to the financial reporting challenge posed by the new programs undertaken to address the economic crisis.

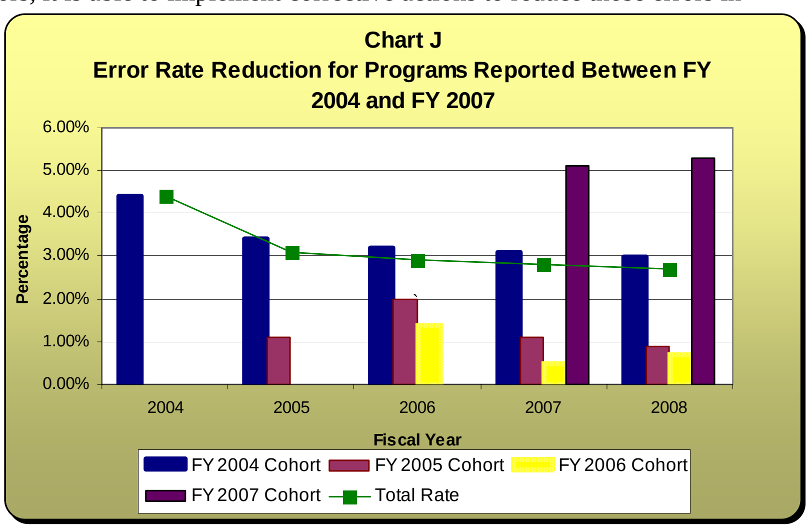
- **The Department of Transportation (DOT).** DOT, for the first time in its history, achieved a clean opinion with no material weaknesses. DOT joins the ranks of the Departments of Justice and Housing and Urban Development as one of the Government's larger and more complex Federal agencies to achieve the important milestone of a clean opinion with no material weaknesses.

In addition to these results, the total number of material weaknesses Government-wide declined from 39 to 32 (or 18 percent), primarily from a reduction in Financial Systems and Security material weaknesses. The remaining 32 material weaknesses are primarily comprised of weaknesses related to Financial Management and Reporting, Financial Systems and Security, Property, Plant & Equipment (PP&E), and Budgetary Reporting. Examples of these weaknesses entail improvements needed in controls over: the financial statement preparation process, Information Technology security, the receipt and tracking of PP&E, and funds control. This is the fifth year in a row that material weaknesses have declined, with almost a 50 percent decrease in weaknesses since 2001.

Eliminating Improper Payments

Fiscal Year 2008 was also an important year for identifying, measuring, and eliminating improper payments (e.g., the right amount, to the right recipient). Full transparency of annual improper payment totals allows the public to understand the extent of payment errors and assess the Government's efforts to eliminate them. With this year's financial reports, Federal agencies are now reporting improper payment measurements for nearly 95 percent of all high-risk programs (up from 85 percent in FY 2007), with error rates reported on 12 new programs, including Medicaid and parts of the Medicare program.

The results from the past five years of reporting on improper payments demonstrate that once an agency has measured and reported program errors, it is able to implement corrective actions to reduce those errors in subsequent years. As illustrated in Chart J,[14] Error Rate Reduction for Programs Reported Between FY 2004 and FY 2007, the error rate for the first programs measured, in FY 2004, was 4.4 percent (or $45.1 billion in improper payments). For these programs, the error rate has declined to 3.0 percent (or a $7.1 billion reduction in improper payments). Similar to the progress achieved in programs that first reported in FY 2004, programs that first reported in FYs 2005, 2006, and 2007 have reduced improper payments, representing an $800 million reduction.[15]



With 12 additional programs reporting in FY 2008, the preliminary Government-wide error rate is 3.9 percent or $71.7 billion, an increase of $16.7 billion from FY 2007. The increase is driven primarily by the newly measured programs, which include parts of Medicare and Medicaid. A significant cause of improper payments is insufficient

14 The table does not include programs reporting for the first time in FY 2008.

15 In FY 2007, Medicaid measured one of its components and reported an 18.4 percent error rate. In FY 2008, Medicaid measured all program components and reported a 10.5 percent error rate. For IPIA reporting, Medicaid will be reported in the FY 2008 cohort.

documentation, meaning that all of the supporting documentation necessary to verify the accuracy of the claim was not provided. If all the supporting documentation had been received, the agencies could have better determined whether the payment was appropriate or made in error. As documentation of payments improves, it is anticipated that the amount of payment errors reported will decline significantly.

Asset Management

Under the OMB's Real Property Asset Management initiative, agencies continue to make significant progress implementing the necessary tools to manage the size, condition, and costs of their asset portfolios and comply with Executive Order 13327, Federal Real Property Asset Management. In FY 2008, Executive agencies reported more than 1.1 million assets, including land, buildings, and structures, to the Government-wide real property inventory. This resource provides a more complete picture of the Government's asset inventory; where the assets are located; and how and whether the assets are used effectively to serve agencies' missions and objectives, than was previously possible. A more complete inventory picture and performance information ensures that agencies, and the Government as a whole, can make smarter asset management decisions. Agencies are also using this information to move forward with efforts to improve asset condition, increase asset utilization, and dispose of unneeded assets.

OMB continues holding agencies accountable for their asset management goals through the Real Property Asset Management process. Since FY 2004, agencies have significantly improved their asset management processes and their ability to gather and use inventory and performance data to drive the decision-making process toward rightsizing the Government's real property assets. To this end, Executive agencies have disposed of more than $8 billion in real property assets and are well on the way to meeting OMB's goal of disposing $9 billion in assets by the close of FY 2009.

Systems, Controls, & Legal Compliance

Systems

As Federal agencies demonstrate success in obtaining and keeping an unqualified opinion on their audited financial statements, the Federal Government continues to face challenges in implementing financial systems that meet Federal requirements. Although the number of agencies in compliance with the Federal Financial Management Improvement Act (FFMIA) continued to increase in fiscal year 2008 from 14 to 15, the number of auditors reporting compliance with FFMIA decreased from 11 to 10. The annual changes in compliances reported each year underscores the importance of current initiatives to standardize the financial management practices across the Federal Government.

In addition, OMB has continued to standardize common business processes across the Government, create opportunities for agencies to move financial systems to shared service providers, and increase transparency by establishing performance measures to evaluate the results. These efforts will help agencies implement financial systems that are compliant with Federal requirements and improve the cost, quality, and performance in the Government's financial management systems.

This year, OMB will be updating Circular No. A-127, *Financial Management Systems*. The revised Circular will clarify the definition of FFMIA substantial compliance so that auditors and agency heads interpret the guidance more consistently. This effort will further improve management of financial systems.

Controls

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

The OMB Circular No. A-123 is the policy document that implements the requirements of the Federal Managers' Financial Integrity Act (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 the internal control over financial reporting. Appendix B requires agencies to maintain internal control that reduces the risk of fraud, waste, and error in government charge card programs. Appendix C implements the requirements of the Improper Payment Information Act, which includes the measurement and remediation of improper payments.

Law & Policy	What it Does
Federal Managers' Finanical Integrity Act of 1982	requires the head of each executive agency to annually prepare a statement reporting the effectiveness of the agency's internal control and whether its systems comply with the federal financial system requirements.
Federal Financial Management Improvement Act of 1996	requries that Federal financial management systems provide accurate, reliable, and timely financial management information to the Government's managers.
OMB Circular A-123	provides instruction to agencies for implementing the **FMFIA**
OMB Circular A-127	provides instruction for complying with the federal financial system requirements.

In FY 2008, agencies continued to implement the requirements of FMFIA and Circular No. A-123 and have made much progress. The 24 major CFO Act agencies completed the third year of the more rigorous assessment of the internal control over financial reporting as required by the A-123 Appendix A. This year, 22 of the 24 major CFO Act agencies completed a full scope Appendix A assessment of the internal control over financial reporting (testing all key processes) as compared to 17 agencies last year. During FY 2009, OMB will continue working with the remaining two agencies that have not yet completed the full scope assessment. During FY 2008, OMB facilitated a forum on the better integration and leverage of internal control reviews being performed throughout departments and agencies through the exploration of alternate frameworks and implementation strategies. The forum included representatives from the financial, audit, acquisition, program, and information technology communities. Due to the myriad of legislative and regulatory requirements, internal control reviews, to satisfy those legislative and regulatory requirements, have been layered upon each other rather than being integrated. This forum included a robust discussion of alternatives and current practices that will inform potential next steps in future guidance.

This year, OMB will be updating Circular No. A-123, Appendix B. The revised appendix will expand the scope to include convenience checks, introduce a disciplinary framework for charge card abuse, and discuss the accounting for property purchased with charge cards.

Pursuant to Circular No. A-123, Appendix C, Federal agencies are now reporting improper payment measurements for nearly 95 percent of all high-risk outlays and reported error rates for 12 new programs (see Eliminating Improper Payments section for more details).

While many agencies are making progress identifying and resolving deficiencies found in internal control, continued diligence and commitment are needed. However, effective internal control is not only a challenge at the agency level, but it is also a challenge at the Government-wide level. Consequently, GAO has issued an adverse opinion on the effectiveness of the internal control for the Government as a whole, in its report.

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.

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, are also available at the Treasury, OMB, and GAO websites at: http://www.fms.treas.gov/fr/index.html; http://www.whitehouse.gov/omb/financial/index.html; and www.gao.gov, respectively. Other related Government publications include, but are not limited to the:

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

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