MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The fiscal year (FY) *2012 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, including 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 (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). As it has for the past fifteen years, GAO issued a "disclaimer" of opinion on the accrual-based, consolidated financial statements for the fiscal years ended September 30, 2012 and 2011. GAO also issued disclaimers of opinion on the 2012, 2011, and 2010 Statements of Social Insurance (SOSI), following unqualified opinions on the 2008 and 2009 SOSI, and a disclaimer of opinion on the 2012 and 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 accordance with Generally Accepted Accounting Principles (GAAP). In FY 2012, 31[1] of the 35 most significant agencies earned unqualified opinions on their financial statement audits.[2]

The FY 2012 *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;
- Required Supplementary Information, Required Supplementary Stewardship Information, and Other Accompanying 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.

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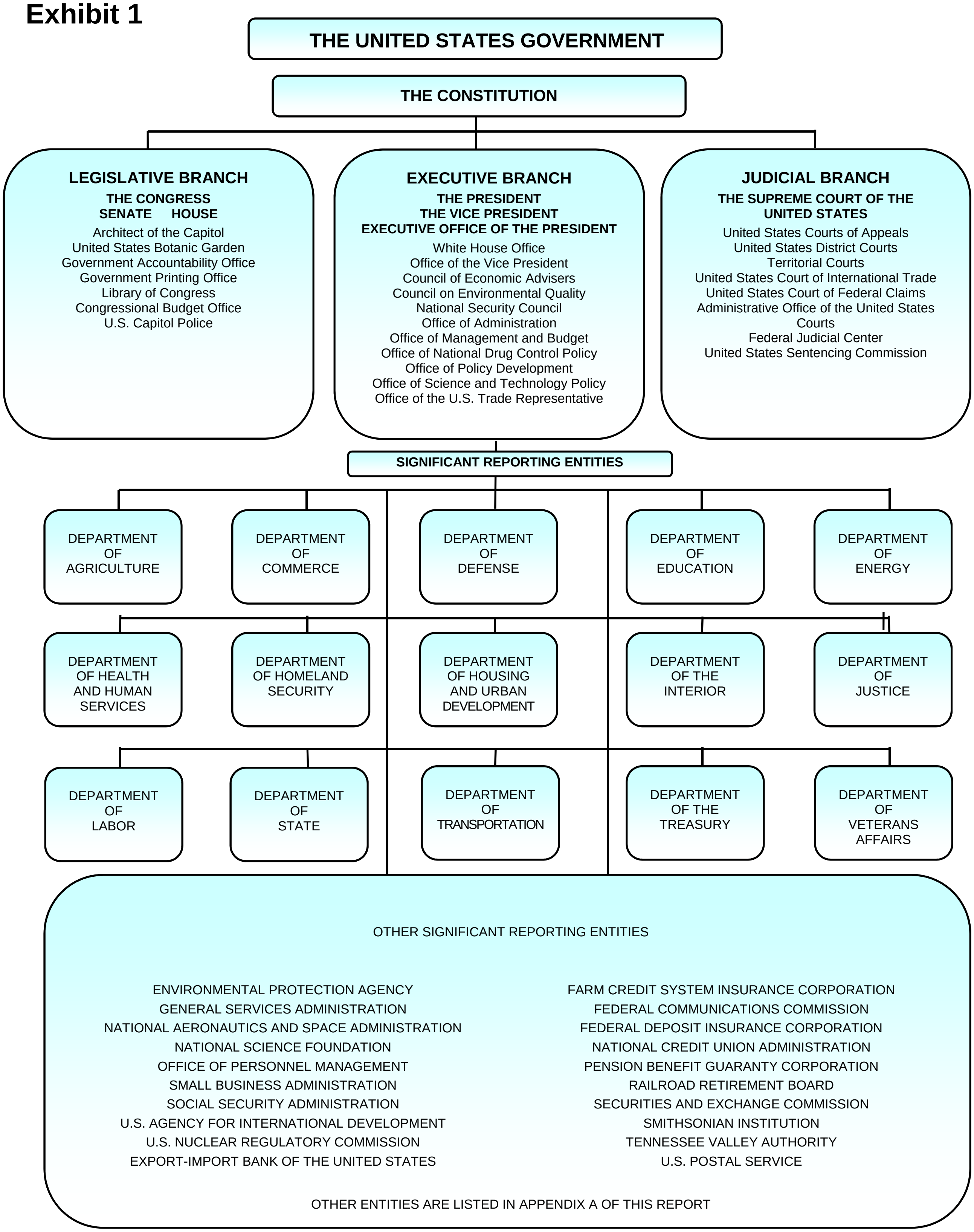
[1] The 31 agencies include the Department of Health and Human Services, which received a disclaimer of opinion on its 2012, 2011, and 2010 SOSI and on its 2012 and 2011 SCSIA.

[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 2012 audits are not yet complete. Statistic reflects 2011 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	2012	2011	Increase / (Decrease) $	Increase / (Decrease) %
FINANCIAL MEASURES				
Gross Cost	$ (3,844.9)	$ (3,998.3)	**$ (153.4)**	**(3.8%)**
Less: Earned Revenue	$ 350.8	$ 365.6	$ (14.8)	(4.0%)
Gain/(Loss) from Changes in Assumptions	$ (320.2)	$ (28.1)	$ 292.1	1039.5%
Net Cost[1]	**$ (3,814.3)**	**$ (3,660.8)**	**$ 153.5**	**4.2%**
Less: Taxes and Other Revenue:	$ 2,518.2	$ 2,363.8	$ 154.4	6.5%
Unmatched Transactions & Balances	$ (20.2)	$ (15.6)	$ 4.6	29.5%
Net Operating Cost[2]	**$ (1,316.3)**	**$ (1,312.6)**	**$ 3.7**	**0.3%**
Assets[3]:				
Cash & Other Monetary Assets	$ 206.2	$ 177.0	$ 29.2	16.5%
Loans Receivable and Investments, Net[4]	$ 1,009.1	$ 985.2	$ 23.9	2.4%
Property, Plant & Equipment, Net	$ 855.0	$ 852.8	$ 2.2	0.3%
Other	$ 678.0	$ 692.3	$ (14.3)	(2.1%)
Total Assets	**$ 2,748.3**	**$ 2,707.3**	**$ 41.0**	**1.5%**
Liabilities[3]:				
Federal Debt Held by the Public & Accrued Interest	$ (11,332.3)	$ (10,174.1)	$ 1,158.2	11.4%
Federal Employee & Veterans Benefits	$ (6,274.0)	$ (5,792.2)	$ 481.8	8.3%
Other	$ (1,243.0)	$ (1,526.4)	$ (283.4)	(18.6%)
Total Liabilities	**$ (18,849.3)**	**$ (17,492.7)**	**$ 1,356.6**	**7.8%**
Net Position (Assets minus Liabilities)	**$ (16,101.0)**	**$ (14,785.4)**	**$ (1,315.6)**	**(8.9%)**
SUSTAINABILITY MEASURES				
Social Insurance Net Expenditures[5]:				
Social Security (OASDI)	$ (11,278)	$ (9,157)	$ 2,121	23%
Medicare (Parts A, B, & D)	$ (27,174)	$ (24,572)	$ 2,602	11%
Other	$ (102)	$ (101)	$ 1	1%
Total Social Insurance Net Expenditures	**$ (38,554)**	**$ (33,830)**	**$ 4,724**	**14.0%**
Total Federal Government Noninterest Net Expenditures[6]	**$ (16,500)**	**$ (6,400)**	**$ 10,100**	**157.8%**
BUDGET DEFICIT				
Unified Budget Deficit[7]	**$ (1,089.4)**	**$ (1,298.6)**	**$ (209.2)**	**(16.1%)**

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 Required Supplementary Information section of the *Report*.

7 Source: Final Monthly Treasury Statement (as of 9/30/2012 and 9/30/2011).

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 by about 4 percent to $3.8 trillion. Deducting $350.8 billion in revenues earned for goods and services provided to the public (e.g., Medicare premiums and national park fees) and adding $320.2 billion in losses from changes in assumptions yields a net cost of $3.8 trillion.
- Taxes and other revenues increased $154.4 billion to $2.5 trillion, which, when offset against the Government's net cost, results in a "bottom line" net operating cost of $1.3 trillion.
- Comparing total 2012 Government assets of $2.7 trillion to total liabilities of $18.8 trillion yields a negative net position of $16.1 trillion. Government liabilities are comprised mostly of $11.3 trillion in Federal debt held by the public and accrued interest payable[3] and $6.3 trillion of Federal employee and veteran benefits payable.
- As of September 30, 2012, the Government's total debt subject to the debt limit was $16.027 trillion. Pursuant to the Budget Control Act of 2011 (BCA), the debt limit was increased by $1.2 trillion to $16.394 trillion in January 2012.

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 Required Supplementary 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 2012 SOSI, projected social insurance expenditures exceeded projected revenues by about $38.6 trillion, a nearly $4.8 trillion increase over 2011 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 present value of the Government's total projected, non-interest expenditures (including its social insurance programs) are projected to exceed total projected receipts by $16.5 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 $3.5 trillion net of receipts of $2.4 trillion yielded a unified budget deficit that decreased from $1.3 trillion (8.7 percent of GDP) in FY 2011 to $1.1 trillion (7.0 percent of GDP) in FY 2012.[6]
- The Government borrows from the public to finance the gap between its primarily cash-based outlays and receipts and to finance certain cash transactions that are not reflected in the deficit. For FY 2012, debt held by the public, excluding interest payable, of $11.3 trillion, equates to 73 percent of GDP.
- The projected $38.6 trillion net present value excess of expenditures over receipts over 75 years for the programs reported in the 2012 SOSI represents about 4.4 percent of the present value of GDP over 75 years. The excess of total projected non-interest spending over receipts of $16.5 trillion discussed in the 'Statement of Long Term Fiscal Projections' in the Required Supplementary Information section of the *Report* represents 1.7 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 and premiums. By accounting convention, general revenues transferred to Medicare Parts B and D 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, 2012 and 2011), 10/12/12 press release.

Fiscal Year 2012 Financial Statement Audit Results

For FY 2012, the Government Accountability Office (GAO) issued a sixteenth consecutive disclaimer of audit opinion on the accrual-based, government-wide financial statements. In addition, GAO issued disclaimers of opinion on the 2012, 2011, and 2010 Statements of Social Insurance (SOSI), following unqualified opinions on the 2009 and 2008 SOSI, and disclaimers of opinion on the 2012 and 2011 Statement of Changes in Social Insurance Amounts (SCSIA). The SOSI and 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 2010-2012 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 10 of 11 additional significant reporting agencies, (see Table 2 and Appendix A for a list of these agencies)[7].

Table 2: FY 2012 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)	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)	Unqualified
Department of Transportation (DOT)	Unqualified
Department of the Treasury (Treasury)	Unqualified
Department of Veterans Affairs (VA)	Unqualified
Agency for International Development (USAID)	Qualified
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)[2]	Unqualified
Federal Communications Commission (FCC)	Unqualified
Federal Deposit Insurance Corporation (FDIC)[2]	Unqualified
National Credit Union Administration (NCUA)[2]	Unqualified
Pension Benefit Guaranty Corporation (PBGC)	Unqualified
Railroad Retirement Board (RRB)	Disclaimer
Securities and Exchange Commission (SEC)	Unqualified
Smithsonian Institution[3]	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] Entities operate under calendar year (CY)-end. Opinions reflect CY 2011 audit results.

[3] Opinion on the most recent annual report, covering FY 2011.

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 through the Troubled Asset Relief Program (TARP). Following 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

[7] The Department of Health and Human Services received a disclaimer of opinions on its 2012, 2011, and 2010 SOSI and its 2012 and 2011 SCSIA.

beneficial majority equity investment. Even though some of the equity investments are significant, the entities in which the Federal Government holds equity investments meet the criteria under paragraph 50 of the Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, which directs that 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 2012, the budget, the economy, the debt, 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 *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 decreased from approximately $1.3 trillion in FY 2011 to about $1.1 trillion in FY 2012. The Government's largely accrual-based net operating cost (which remained essentially unchanged at $1.3 trillion in FY 2012) typically exceeds the deficit due largely to the inclusion of cost accruals associated with 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 estimated 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. Other programs that are subject to significant estimated liabilities and changes in those amounts can also impact net cost, but not the deficit.

Table 3 shows that, for FY 2012, the $226.9 billion net difference between the Government's budget deficit of $1.1 trillion and net operating cost of $1.3 trillion is predominantly due to large, yet offsetting changes in: (1) liabilities for Federal employee and veteran benefits payable ($481.8 billion increase), and (2) liabilities to Government-Sponsored Enterprises (GSEs) – Fannie Mae and Freddie Mac ($307.2 billion decrease) in FY 2012, compared to smaller changes for these same amounts in FY 2011 ($71.9 billion increase and $43.7 billion decrease, respectively). As discussed later, changes in future estimated employee and veteran benefits liabilities stem from several factors, including experience losses or gains and changes in economic and demographic assumptions. The GSE estimated liabilities decreased significantly due primarily to an amended dividend provision of the Senior Preferred Stock Purchase Agreements (SPSPAs) with the GSEs that is expected to drive downward the amount of future draws needed by the GSEs.

Table 3: Budget Deficit vs. Net Operating Cost

Dollars in Billions	2012	2011	Increase / (Decrease)
Net Operating Cost	**$ (1,316.3)**	**$ (1,312.6)**	**$ 3.7**
Change in:			
Federal Employee and Veteran Benefits Payable	$ 481.8	$ 71.9	$ 409.9
Liabilities to Government-Sponsored Enterprises	$ (307.2)	$ (43.7)	$ (263.5)
Other, Net	$ 52.3	$ (14.2)	$ 66.5
Subtotal - Net Difference:	$ 226.9	$ 14.0	$ 212.9
Budget Deficit	**$ (1,089.4)**	**$ (1,298.6)**	**$ (209.2)**

The ***Reconciliation of Net Operating Cost and Unified Budget Deficit Statement***, as summarized in Table 3, 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.

[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.

Table 4: Gross Cost, Revenues, and Net Cost

Dollars in Billions		2012		2011	Increase / (Decrease) $		Increase / (Decrease) %
Gross Cost	**$**	**(3,844.9)**	**$**	**(3,998.3)**	**$**	**(153.4)**	**(3.8%)**
Less: Earned Revenue[1]	$	350.8	$	365.6	$	(14.8)	(4.0%)
Subtotal	**$**	**(3,494.1)**	**$**	**(3,632.7)**	**$**	**(138.6)**	**(3.8%)**
Gain/(Loss) from Changes in Assumptions[2]	$	(320.2)	$	(28.1)	$	292.1	1039.5%
Net Cost	**$**	**(3,814.3)**	**$**	**(3,660.8)**	**$**	**153.5**	**4.2%**
Less: Taxes and Other Revenue	$	2,518.2	$	2,363.8	$	154.4	6.5%
Unmatched Transactions and Balances[3]	$	(20.2)	$	(15.6)	$	4.6	29.5%
Net Operating Cost	**$**	**(1,316.3)**	**$**	**(1,312.6)**	**$**	**3.7**	**0.3%**

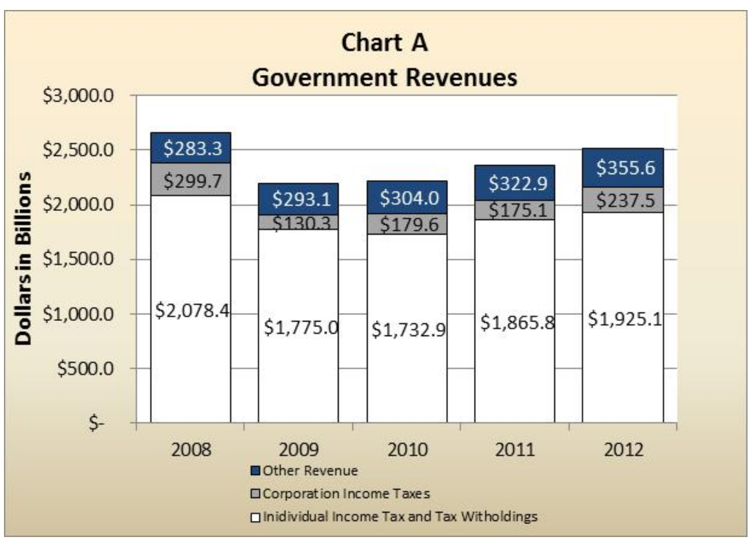
1 Revenues earned for goods and services provided (e.g., Medicare premiums, national park entry fees, and postal fees)

2: Changes in assumptions used to estimate liabilities for federal employee pensions and other retirement and postemployment benefits.

3: Represents unreconciled differences in intragovernmental activity and balances between Federal agencies.

Table 4 shows that the Government's "bottom line" net operating cost remained essentially unchanged, increasing less than one-half of 1 percent from $1,312.6 billion in FY 2011 to $1,316.3 billion in FY 2012. As discussed below, this slight change includes significant, yet offsetting changes in accrued or estimated future costs associated with Federal employee and veteran benefits programs and the GSEs.

Revenue: "What Came In"

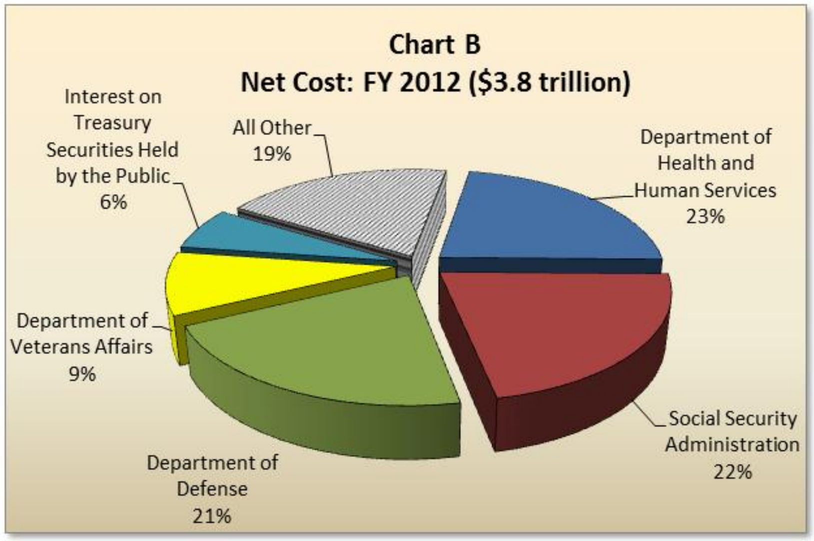


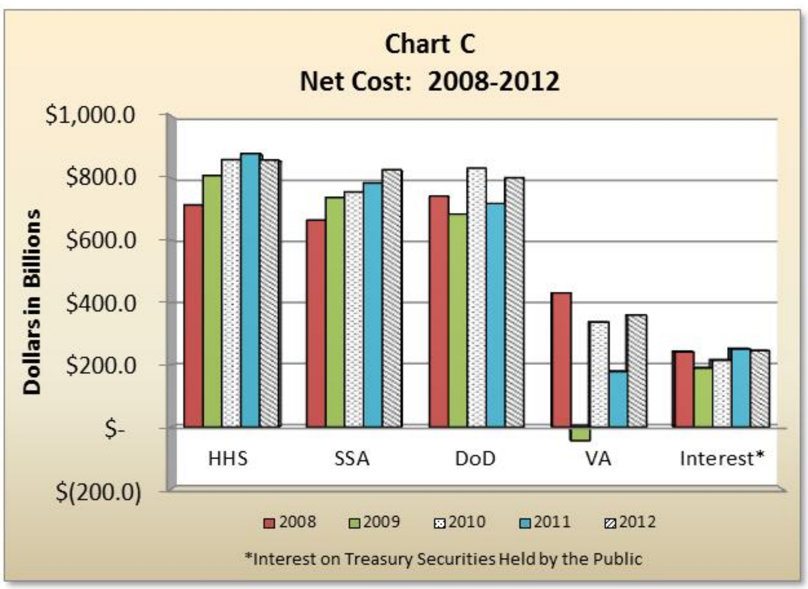
The ***Statement of Net Cost*** reports "earned" revenue generated by Federal programs, including Medicare premiums paid by program participants and postal service fees. The ***Statement of Operations and Changes in Net Position*** shows the Government's taxes and other revenues (i.e., revenues other than "earned"). Chart A shows that increases in each of the three revenue categories shown - individual income tax and withholdings, corporate income taxes, and other revenues - combined to increase total Government revenues by $154.4 billion (6.5 percent) to just over $2.5 trillion for FY 2012. Together, personal and corporate income taxes accounted for about 86 percent of total revenues in FY 2012. 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 *net cost* 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 *net operating cost*.

Chart B shows the composition of the Government's net cost (gross cost less earned revenue and gain/loss from changes in assumptions) of $3,814.3 billion in FY 2012, a $153.5 billion (4.2 percent) increase compared to FY 2011. In FY 2012, 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 B and C. The bulk of HHS and SSA net costs (which totaled $856.5 billion and $825.1 billion in FY 2012, respectively) are attributable to major social insurance programs administered by these agencies, e.g., Medicare by HHS and Social Security by SSA. 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 $799.1 billion relate primarily to military operations and personnel, but as noted above, the longer-term costs of military retirement and health benefits accounted for most of DoD's cost increase in FY 2012. Charts B and C 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 for FY 2012. The combined other agencies included in the Government's Statement of Net Cost accounted for 19 percent of the Government's total net cost.





As indicated earlier, the change in the Government's net cost ($153.5 billion or 4.2 percent) and minimal change in net operating cost ($3.7 billion or 0.3 percent) both include the individual, offsetting effects of changes in the current costs of and especially the changes in actuarial and other estimated costs associated with: (1) the Government's postemployment benefits programs for its military and civilian employees and veterans, and (2) liabilities to the GSEs, specifically Fannie Mae and Freddie Mac, which relates to the Government's economic recovery efforts.

DOD, VA, and OPM each attributed significant increases in their respective agency total net costs largely to changes in assumptions related to the Government's postemployment benefits programs. Table 4 on page 8 shows that the losses associated with changes in these assumptions totaled $320.2 billion in FY 2012, compared to $28.1 billion in FY 2011 – an increase of $292.1 billion. These agencies, including but not limited to DOD, VA, and OPM, employ a complex series of assumptions, including but not limited to interest rates, beneficiary eligibility, life expectancy, medical cost levels, compensation levels, disability claims rates, and cost of living to make annual actuarial projections of their long-term benefits liabilities and their related costs.

In addition, the ***Statement of Net Cost*** in this *Report* shows net revenues for the Department of the Treasury of $177.5 billion for FY 2012, compared to a net cost amount of $84.2 billion in FY 2011, a combined decrease of $261.7 billion. Contributing to this substantial decrease was a $288.7 billion reduction in expense associated with Senior Preferred Stock Purchase Agreements (SPSPAs).[11] The SPSPAs are intended to maintain the solvency of GSEs, specifically Fannie Mae and Freddie Mac. During FY 2012, Treasury introduced a revised SPSPA dividend provision, which commences with the quarter ending March 31, 2013. This revision is forecasted to lower the amounts drawn from Treasury under the SPSPAs because the GSEs would no longer need to make draws to fund dividend payments to Treasury. With the revision, dividend payments would be limited to the amount of the positive net worth in excess of a capital reserve amount. Prior to the revision, dividends were forecasted to be paid on an amount that was projected to increase as draws continued to be made to fund the dividends. The expected dividend payments after the revision are lower than previously forecasted. The forecasted effect of the revision is a reduction in the contingent liability, and the net costs associated with the program.

As noted earlier, taxes and other revenues of $2,518.2 billion are deducted from the total net cost of $3,814.3 billion (including actuarial costs) to derive the Government's "bottom line" net operating cost.[12] As previously shown in Table 4, the increase in taxes and other revenues, combined with the increase in net costs, including the effects of the offsetting changes in actuarial and estimated costs described above, result in a "bottom line" net operating cost that remained essentially unchanged at about $1.3 trillion ($1,316.3 billion) for FY 2012, an increase of only $3.7 billion or less than one-half of one percent compared to the FY 2011 net operating cost of $1,312.6 billion.

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

The 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

Table 5: Assets and Liabilities

Net Position Dollars in Billions	2012	2011	Increase (Decrease) $	 %
Assets				
Cash & Other Monetary Assets	$ 206.2	$ 177.0	$ 29.2	16.5%
Loans Receivable and Investments, Net*	$ 1,009.1	$ 985.2	$ 23.9	2.4%
Inventories	$ 299.0	$ 296.1	$ 2.9	1.0%
Property, Plant & Equipment, Net	$ 855.0	$ 852.8	$ 2.2	0.3%
Other	$ 379.0	$ 396.2	$ (17.2)	(4.3%)
Total Assets	**$ 2,748.3**	**$ 2,707.3**	**$ 41.0**	**1.5%**
Less: Liabilities, comprised of:				
Federal Debt Held by the Public & Accrued Interest	$ (11,332.3)	$ (10,174.1)	$ 1,158.2	11.4%
Federal Employee & Veteran Benefits	$ (6,274.0)	$ (5,792.2)	$ 481.8	8.3%
Other	$ (1,243.0)	$ (1,526.4)	$ (283.4)	(18.6%)
Total Liabilities	**$ (18,849.3)**	**$ (17,492.7)**	**$ 1,356.6**	**7.8%**
Net Position (Assets Minus Liabilities)	**$ (16,101.0)**	**$ (14,785.4)**	**$ (1,315.6)**	**(8.9%)**

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

[11] Department of the Treasury FY 2012 Agency Financial Report, p. 101. See also Note 11 – Investments in and Liabilities to GSEs – of this *Report*.

[12] 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 Other Accompanying Information section of this *Report*.

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 required supplementary disclosures of this *Report*.

Assets – "What We Own"

As of September 30, 2012, the Government held about $2.7 trillion in assets, an increase of $41.0 billion (1.5 percent). The Government's assets are comprised mostly of net property, plant, and equipment ($855.0 billion in FY 2012) and a combined total of $1,009.1 billion in net loans receivable ($859.6 billion), and direct loans and investments ($149.5 billion) associated with TARP and the GSEs, specifically Fannie Mae and Freddie Mac.

The Department of Education's (Education's) direct loan programs accounted for $673.2 billion (78.3 percent) of total net loans receivable. Education's receivables balances increased by 44 percent ($161.7 billion) during FY 2011 and 27 percent ($143.7 billion) during FY 2012 primarily due to legislation requiring a transition for new loans from guaranteed student loans to full direct lending by Education.[13]

Following the financial crisis in 2008, the Government's assets grew with the implementation of these market stabilization and economic recovery initiatives. However, in recent years, with the ongoing wind-down of these recovery programs, the balances of many of these investments have declined principally through repayments and sales.[14] For example:

- Through the TARP programs, the Treasury made direct loans and equity investments, and entered into other credit programs. As of September 30, 2012, the estimated fair value of the outstanding portfolio of TARP net direct loans and equity investments was $40.2 billion, compared to $80.1 billion at the end of FY 2011. The cumulative net cost of TARP from inception through September 30, 2012 amounts to $20.3 billion. As of September 30, 2012, via sales, collections, and other income, Treasury has collected 88.5 percent of the $417.6 billion in program funds disbursed under TARP. In FY 2012, Treasury collected about $53.3 billion from TARP participants. TARP's authority to make new commitments to purchase or guarantee troubled assets expired on October 3, 2010. Today, Treasury is focused on winding down TARP by exiting the remaining TARP investments in a manner that balances the need to exit these investments as quickly as practicable with maximizing returns.[15]
- Working with the Federal Reserve Bank of New York (FRBNY), Treasury made substantial progress in winding down the investments in American International Group (AIG). During the financial crisis, the peak amount of assistance offered to AIG by the FRBNY and Treasury was $182.3 billion, of which AIG drew a total of $160.2 billion in Federal assistance. AIG has fully repaid the FRBNY with proceeds in excess of cost of $17.7 billion. Treasury has sold a total of 1.4 billion AIG shares, including 0.9 billion TARP shares, and held 15.9 percent of AIG's outstanding common stock as of September 30, 2012.[16]
- The GSE Mortgage-Backed Securities (MBS) Purchase Program under the Housing and Economic Recovery Act (HERA) authorized Treasury to purchase GSE MBS consisting of mortgage pass-through securities issued by Fannie Mae and Freddie Mac. Between October 2008 and December 31, 2009, Treasury purchased $225 billion in agency-guaranteed MBS. During FY 2012, Treasury completed the orderly sale of this portfolio,[17] and reported that overall, cash returns of $250 billion were received from the MBS portfolio through sales, principal, and interest.[18]
- Amounts invested in the GSEs through Senior Preferred Stock Purchase Agreements (SPSPAs) are intended to help maintain the solvency of Fannie Mae and Freddie Mac. As of September 30, 2012, the fair value of Treasury's portfolio of SPSPA investments totaled $109.3 billion compared to $133.0 billion as of September 30, 2011. This decrease was attributable in part to an expected decrease in future dividend

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[13] U.S. Department of Education's FY 2012 Agency Financial Report, p. 58.

[14] As of September 30, 2012, TARP Direct Loans and Equity Investments and Investments in Government-Sponsored Enterprises (GSEs) represented 1.5 percent and 4.0 percent of total assets, respectively.

[15] Department of the Treasury FY 2012 Agency Financial Report, pp. 11, 87. See also Note 5 – TARP Direct Loans and Equity Investments and Note 28 – Subsequent Events – of this *Report*. Additional information concerning the TARP programs and other related initiatives can be found at www.financialstability.gov.

[16] Department of the Treasury FY 2012 Agency Financial Report, pp.11, 89. See also Note 5 – TARP Direct Loans and Equity Investments and Note 28 – Subsequent Events – of this *Report*.

[17] Department of the Treasury FY 2012 Agency Financial Report, pp. 11, 104.

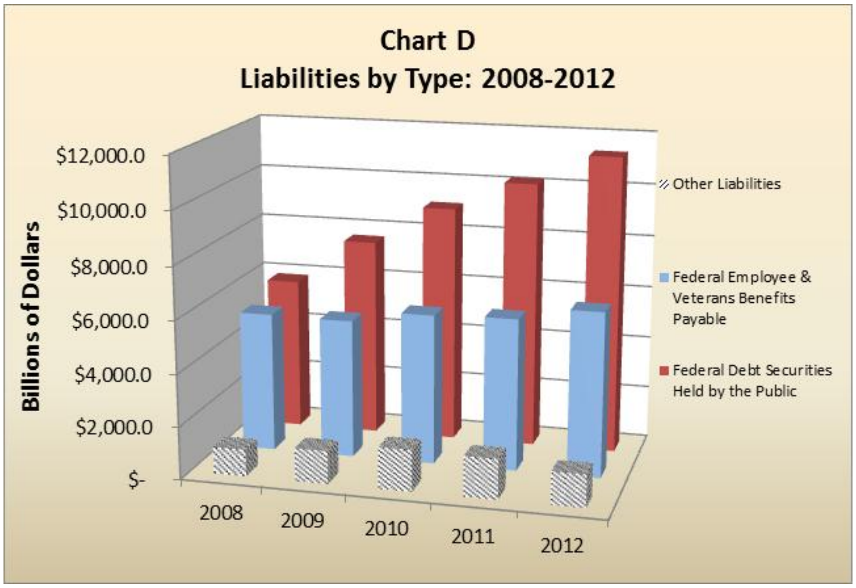
[18] Department of the Treasury FY 2012 Agency Financial Report, p. 159.

payments due to a change made during FY 2012 to the SPSPA dividend calculation. This change, which commences with the quarter ending March 31, 2013, will lower the amount of funds drawn from Treasury under the SPSPAs, because the GSEs would no longer need to make draws to fund dividend payments to Treasury. Furthermore, with this dividend change, all GSE earnings above a threshold are paid as dividends to the Government for its investment in the GSEs. Under the amended SPSPAs, the quarterly dividend payment will change from a 10.0 percent per annum fixed rate to an amount equivalent to each GSE's positive net worth above a capital reserve amount. This change had a significant impact on the related SPSPA contingent liability representing the total estimated future payments to (draws by) GSEs for the remaining life of the agreements. Due in large part to the dividend change, which significantly decreased the need for draws due to dividends, the SPSPA contingent liability decreased from $316.2 billion in FY 2011 to $9.0 billion as of September 30, 2012.[19]

Beyond these assets, other significant resources are available to the Government, including stewardship assets, such as natural resources, and the Government's power to tax and set monetary policy.

Liabilities – "What We Owe"

As indicated in Table 5 and Chart D, of the Government's $18.8 trillion in total liabilities, the largest liability is Federal debt held by the public and accrued interest, the balance of which increased $1.2 trillion (11.4 percent) to $11.3 trillion as of September 30, 2012.



The other major component of the Government's liabilities is Federal employee postemployment and veteran benefits payable (i.e., the Government's pension and other benefit plans for its military and civilian employees), which increased $481.8 billion (8.3 percent) during FY 2012, from $5,792.2 billion to $6,274.0 billion. OPM administers the largest civilian pension plan, covering nearly 2.8 million current employees[20] and 2.5 million annuitants.[21] 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.[22]

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 Federal debt held by the public, and accrued interest, which is reported on the Government's balance sheet as a liability, 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

[19] Department of the Treasury FY 2012 Agency Financial Report, pp. 11, 98-100. See also Note 11 – Investments in and Liabilities to GSEs – of this *Report*.

[20] As of 9/30/2012 OPM Office of Actuaries.

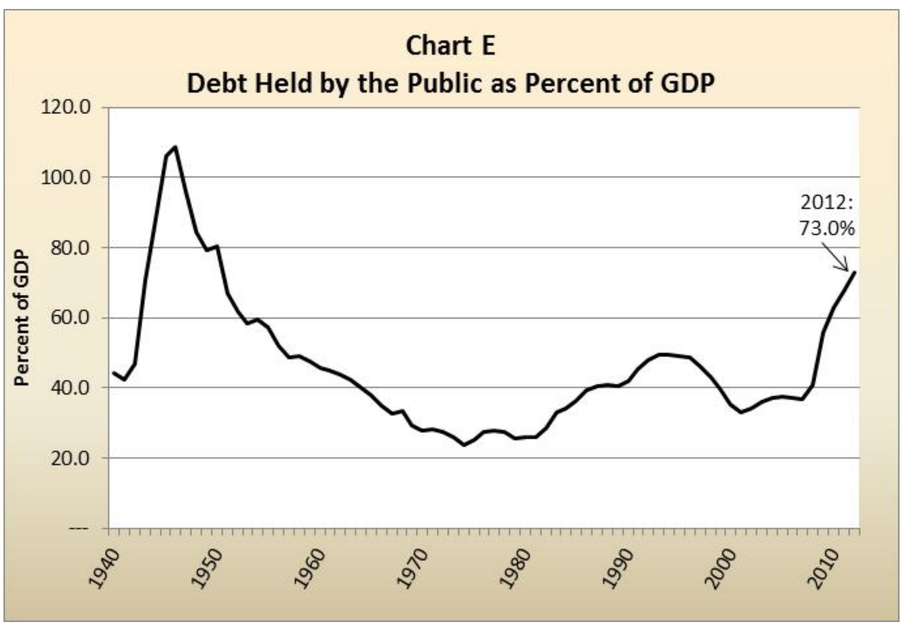
[21] OPM FY 2012 Agency Financial Report, p. 9.

[22] DOD FY 2012 Agency Financial Report, p.12; DOD Military Retirement Fund (MRF) financial statements, p. 14.

individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Federal Government. Federal debt held by the public and accrued interest totaled $11.3 trillion as of September 30, 2012. 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 2012, new borrowings were $7.8 trillion and repayments of maturing debt held by the public were $6.6 trillion. Both represented slight decreases over new borrowings and debt repayments as compared to FY 2011.

In addition to debt held by the public, the Government has about $4.9 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 ($297.6 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) over disbursements 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). When those securities are redeemed, e.g., to pay future Social Security benefits, the Government will need to obtain the resources necessary to reimburse the trust funds. The sum of debt held by the public and intragovernmental debt equals gross Federal debt, which (with some adjustments) is subject to a statutory ceiling (i.e., the debt limit). At the end of FY 2012, debt subject to the statutory limit was $16.027 trillion, $367 billion under the current limit of $16.394 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. With the Public Debt Act of 1941 (Public Law 77-7), Congress and the President set an overall limit of $65 billion on Treasury debt obligations that could be outstanding at any one time. Since then, Congress and the President have enacted a number of debt limit increases. Most recently, pursuant to the Budget Control Act (BCA) of 2011, the debt limit was raised by $400 billion in August 2011 to $14.694 trillion, by $500 billion in September 2011 to $15.194 trillion, and by $1.2 trillion to $16.394 trillion in January 2012.[23]



The Federal debt held by the public measured as a percent of GDP (debt-to-GDP ratio) (Chart E) compares the country's debt to the size of its economy, making this measure sensitive to changes in both. Over time, the debt-to-GDP ratio 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

[23] See also Note 28 - Subsequent Events – of this *Report*.

shown in Chart E, 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-to-GDP ratio up to about 73 percent as of September 30, 2012.

The Economy in Fiscal Year 2012

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, and at a faster rate, during FY 2012. Job growth accelerated, with private nonfarm payrolls rising by 1.9 million after a gain of 1.8 million the previous fiscal year. The unemployment rate declined during FY 2012 but remained elevated.

After rising by 1.6 percent during FY 2011, real GDP growth accelerated to an annual average rate of 2.5 percent over the four quarters of FY 2012. The economy added 1.9 million total nonfarm payroll jobs during FY 2012, more than the 1.8 million nonfarm payroll jobs added during FY 2011. The unemployment rate declined from 9.1 percent in September 2011 to 7.8 percent in September 2012. After accelerating in the two previous fiscal years, inflation slowed, mainly reflecting lower energy and food price inflation. Underlying inflation (the core rate, excluding food and energy) stabilized at the previous fiscal year's level and remained low by historical standards. Real wages for private production nonsupervisory workers declined, reflecting slower nominal wage growth relative to the rise in consumer prices. The level of corporate profits increased in FY 2012, and at a much faster pace than in the previous fiscal year. Federal spending declined, and federal tax receipts grew in FY 2012. As a result, the Federal unified budget deficit fell to $1.1 trillion in FY 2012, and also narrowed as a share of the economy to 7.0 percent of GDP from 8.7 percent in FY 2011.

Table 6: National Economic Indicators*

	FY 2012	FY 2011
Real GDP Growth	2.5%	1.6%
Residential Investment Growth	13.7%	1.4%
Average monthly payroll job change (thousands)	156	151
Unemployment rate (percent, end of period)	7.8%	9.1%
Consumer Price Index (CPI) inflation	2.0%	3.9%
Core CPI (excluding food and energy) inflation	2.0%	2.0%
Treasury constant maturity 10-year rate (end of period)	1.65%	1.9%
Moody's Baa bond rate (end of period)	4.7%	5.2%

* Some FY2011 data may differ from the FY2011 Report due to updates and revisions.

The following key points summarize economic performance in FY 2012:

- Consumer spending rose 1.8 percent during FY 2012, slowing from 2.5 percent during FY 2011.
- Residential fixed investment strengthened notably during FY 2012, jumping by 13.7 percent over the four quarters of FY 2012, compared with 1.4 percent during FY 2011. Nonresidential fixed investment grew 4.5 percent, however, slowing from a 10.1 percent increase during the previous fiscal year.
- Labor market conditions improved further during FY 2012, despite a moderation in the pace of job growth in the middle of the fiscal year. Over the entire fiscal year, total nonfarm payroll employment advanced at an average rate of 156,000 jobs per month, slightly faster than the average monthly increase of 151,000 in

FY 2011. The number of unemployed persons fell to 12.1 million in FY 2012 from 13.9 million in FY 2011. The unemployment rate stood at 7.8 percent in September 2012, down from 9.1 percent at the end of FY 2011, or 1.3 percentage points lower. At the end of FY 2012, the unemployment rate was 2.2 percentage points lower than the recent peak of 10.0 percent, reached in October 2009.

- The overall price level, as measured by the consumer price index (CPI), rose 2.0 percent during FY 2012, restrained by slower energy and food prices. During FY 2011, the CPI increased by 3.9 percent. Core inflation (which excludes food and energy) was also 2.0 percent during FY 2012, unchanged from the previous fiscal year.
- Financial markets conditions and measures of financial risk generally remained stable in FY 2012:
    - Corporate debt yields on bonds of moderate risk stood at about 330 basis points above the rate on 10-year Treasury securities at the end of FY 2011. After fluctuating above and below that level through much of the following fiscal year, the spread narrowed during the final quarter of FY 2012 and ended the fiscal year at 307 basis points.
    - The difference between the 3-month London Interbank Offered Rate (LIBOR) and the 3-month Treasury rate stood at 43 basis points at the end of FY 2011. This spread generally narrowed over the course of the latest fiscal year, ending FY 2012 at 30 basis points.
    - The S&P 500 index rose 27.3 percent during the fiscal year just ended, after declining 0.9 percent during FY 2011.

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, 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, 2012 totaled $477.4 billion, as compared to $421.4 billion as of September 30, 2011.[24] It is important to note that amounts spent by the Federal, State, and Local government agencies, as well as by the private sector are constantly changing. Readers may find the most up-to-date information on where and how these funds are being used at www.recovery.gov.

The preceding section has focused on the Federal Government's financial results for FY 2012. The following sections discuss the issue of fiscal sustainability.

[24] Agency Financial & Activity Reports as of September 30, 2012 and 2011. 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

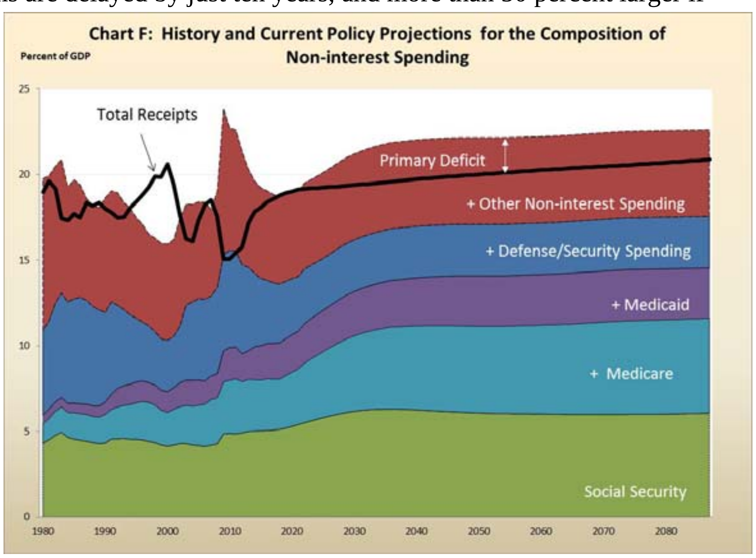
An important purpose of the *Report* is to help citizens understand current fiscal policy and the importance and magnitude of policy reforms necessary to make it sustainable. A sustainable policy is one where the debt–to-GDP ratio is ultimately stable or declining.

To determine if current fiscal policies are sustainable, the projections discussed here assume current policy will be sustained indefinitely and draw out the implications for the growth of debt held by the public as a share of GDP.[25] The projections are therefore neither forecasts nor predictions. As policy changes are enacted, then actual financial outcomes will of course be different than those projected.

The projections presented in this *Report* were finalized prior to the enactment of the American Taxpayer Relief Act (ATRA) in January 2013.[26]

The projections in this *Report* indicate that current policy is not sustainable. The debt-to-GDP ratio is projected to reach 395 percent in 2087 and to rise continuously thereafter. Preventing the debt-to-GDP ratio from rising over the next 75 years is estimated to require some combination of spending reductions and revenue increases that amount to 2.7 percent of GDP over the period. While this estimate of the "75-year fiscal gap" is highly uncertain, current fiscal policies cannot be sustained indefinitely.

It is important to address the Government's fiscal imbalances soon. Delaying action increases the magnitude of spending reductions and/or revenue increases necessary to stabilize the debt-to-GDP ratio. Relative to a reform that begins immediately, for example, it is estimated that the magnitude of reforms necessary to close the 75-year fiscal gap is nearly 20 percent larger if reforms are delayed by just ten years, and more than 50 percent larger if reform is delayed 20 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 debt-to-GDP ratio that the Government controls

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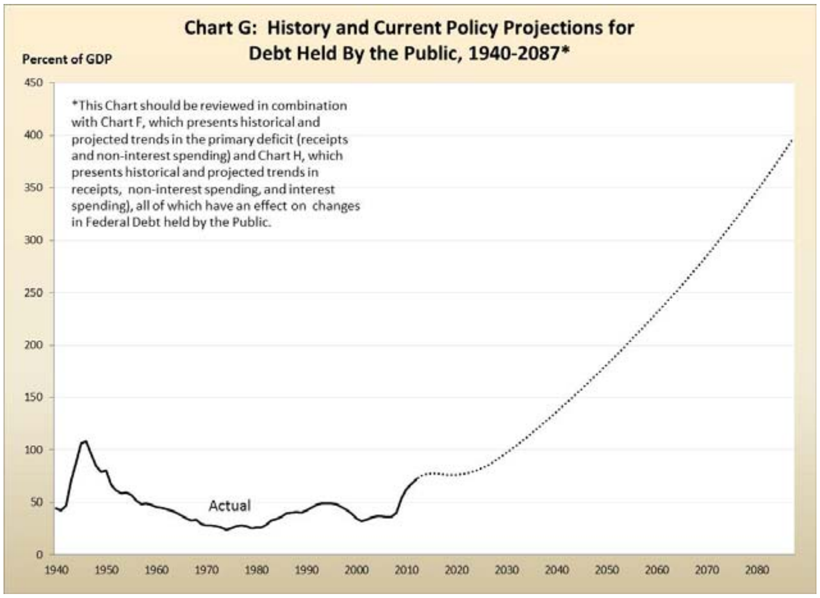
[25] Current policy in the projections is based on current law, but includes extension of certain policies that expire under current law but are routinely extended or otherwise expected to continue, such as extension of relief from the Alternative Minimum Tax (AMT). In addition, the projections in this year's *Report* assume that all of the 2001/2003 tax cuts will be extended indefinitely, whereas the projections in the FY 2011 *Report* assumed that the tax cuts for high-income taxpayers would be allowed to expire.

[26] ATRA did not extend the 2001/2003 tax cuts for high income individuals and families that were assumed to occur in the projections. Updating the projections in this *Report* to account for ATRA would therefore modestly reduce projected long term fiscal imbalances.

directly. (The other determinants are interest rates and growth in GDP). Chart F shows receipts, non-interest spending, and the difference – the primary deficit – expressed as a share of GDP (primary deficit-to-GDP ratio). The primary deficit-to-GDP ratio grew rapidly in 2009 due to the financial crisis and the recession and the Federal Government's response. The ratio stayed large from 2010 to 2012 despite shrinking in each successive year, but is projected to fall rapidly between 2013 and 2018 as the economy recovers and spending reductions called for in the Budget Control Act of 2011 (BCA) take effect, reaching primary balance in 2018 and remaining relatively flat and near zero through 2021. Between 2022 and 2039, however, increased spending for Social Security and health programs due to continued aging of the population and anticipated rising health costs is expected to cause the primary balance to steadily deteriorate and reach 2.3 percent of GDP in 2039. After 2039, the primary deficit-to-GDP ratio slowly declines to 1.7 percent as the impact of the baby boom generation retiring dissipates.

The revenue share of GDP fell substantially in 2009 and 2010 and remained low in 2011 and 2012 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. This ratio is projected to return to near its long-run average as the economy recovers by about 2019, after which 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. This projection assumes that Congress and the President will continue to enact legislation that prevents the share of income subject to the Alternative Minimum Tax from rising.

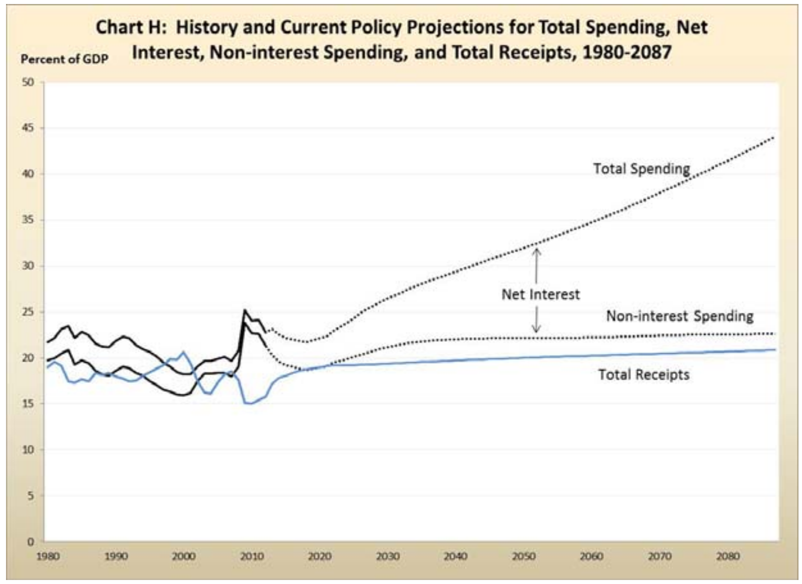
The non-interest spending share of GDP is projected to fall from its current level of 21.3 percent to about 20 percent in 2013, stay at or below that level until 2026, and to then rise gradually to 22 percent of GDP in 2039 and 22.6 percent of GDP in 2087. The reductions in the non-interest spending share of GDP over the next two years are mostly due to the expected reductions in spending for overseas contingency operations, caps on discretionary spending, and the automatic spending cuts mandated by the BCA, and the subsequent increase is principally due to growth in Medicare, Medicaid, and Social Security spending (see Chart F on page 16). 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, 1.8 percentage points, and 1.1 percentage points, respectively. After 2035, the Social Security spending share of GDP is essentially unchanging, 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)[27] provision of health insurance subsidies and expanded Medicaid coverage boost federal spending, and other provisions significantly reduce per-beneficiary Medicare and Medicaid cost growth. On net, the ACA is projected to substantially reduce federal expenditures over the next 75 years. 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.



The primary deficit-to-GDP projections in Chart F on page 16, along with those for interest rates (see Chart H) and GDP, determine the debt-to-GDP ratio projections shown in Chart G . That ratio was 73 percent at the end of fiscal year 2012 and under current policy is projected to be 78 percent in 2022, 145 percent in 2042, and 395 percent in 2087. While these projections are subject to considerable uncertainty, the debt-to-GDP ratio would continue to rise unsustainably under current policy.

[27] P.L. 111-148, as amended by P.L. 111-152. The ACA expands health insurance coverage, provides health insurance subsidies for low-income individuals and families, includes many measures designed to reduce health care cost growth, and reduces the annual increases in Medicare payment rates.

The debt projections in Chart G on page 17 are substantially larger than those projected in last year's *Report*. In 2086, the projected debt-to-GDP ratio is 101 percentage points higher than was projected last year (388 percent versus 287 percent). The difference is primarily due to the changes in the model's technical assumptions, such as: (i) the inclusion of costs for health insurance exchange subsidies; (ii) the assumption in this year's *Report* that all of the 2001/2003 tax cuts will be extended indefinitely, rather than being allowed to expire for high-income taxpayers; and (iii) an improved methodology for projecting Medicare costs.



The Fiscal Gap and the Cost of Delaying Policy Reform

The 75-year fiscal gap is one measure of the degree to which current fiscal policy is unsustainable. It is the amount by which primary surpluses over the next 75 years must rise above current-policy levels in order to prevent the debt-to-GDP ratio from rising. It is estimated that running primary surpluses that average 1.0 percent of GDP over the next 75 years would result in the 2087 debt-to-GDP ratio equaling its level in fiscal year 2012, which compares with primary deficits that average 1.7 percent of GDP under current policies. The 75-year fiscal gap is therefore 2.7 percent of GDP, which is 13.5 percent of the 75-year present value of projected receipts and 12.4 percent of the 75-year present value of non-interest spending.

It is noteworthy that preventing the debt-to-GDP ratio from rising over the next 75 years requires that primary surpluses be substantially positive on average. This is true because projected GDP growth is on average smaller than the projected government borrowing rate over the next 75 years. The implication is that debt would grow faster than GDP if primary surpluses were zero on average. For example, if the primary surplus was precisely zero in every year, then debt would grow at the rate of interest in every year, which would be faster than GDP growth.

Table 7

Costs of Delaying Fiscal Reform

Period of Delay	Change in Average Primary Surplus
No Delay: Reform in 2013.........	2.7 percent of GDP between 2013 and 2087
Ten Years: Reform in 2023........	3.2 percent of GDP between 2023 and 2087
Twenty Years: Reform in 2033..	4.1 percent of GDP between 2033 and 2087

Note: Reforms taking place in 2012, 2022, and 2032 from the 2011 Report were 1.8, 2.2, and 2.8 percent of GDP.

Table 7 illustrates the cost of delaying policy to close the fiscal gap by comparing three policies that begin on different dates. The first policy begins immediately and calls for increasing primary surpluses by 2.7 percent of GDP in every year between 2013 and 2087. This is accomplished by invoking some combination of spending reductions and revenue increases that amount to 2.7 percent of GDP in every year over the 75-year projection period. The second policy in Table 7 begins 2023. Because debt grows unabated between 2013 and 2023 and the same fiscal consolidation must be compressed into ten fewer years, this policy change is more abrupt, calling for primary surplus increases amounting to 3.2 percent of GDP in every year between 2023 and 2087. Similarly, if debt is allowed to accumulate unabated for 20 years, then closing the 75-year fiscal gap would require even more abrupt primary surplus increases amounting to 4.1 percent of GDP in every year between 2033 and 2087. The differences between the primary surplus boost starting in 2023 and 2033 (3.2 and 4.1 percent of GDP, respectively) and the primary surplus boost starting in 2012 (2.7 percent of GDP) is a measure of the additional burden policy delay would impose on future generations. Future generations are harmed by a policy delay of this sort, because the higher the primary surplus is during their lifetimes the greater the difference is between the taxes they pay and the programmatic spending from which they benefit.

Conclusion

The Government took potentially significant steps towards a sustainable fiscal policy by enacting the ACA in 2010 and the BCA in 2011. The ACA holds the prospect of lowering long-term per-beneficiary spending growth for Medicare and Medicaid, and the BCA significantly curtails discretionary spending. Together, these two laws substantially reduce the estimated long-term fiscal gap. But even with the new laws, the debt-to-GDP ratio is projected to increase continuously over the next 75 years and beyond if current policies are kept in place, which implies that current policies are not sustainable. Subject to the important caveat that changes in policy are not so abrupt that they slow the economy's recovery, the sooner policies are put in place to avert these trends, the smaller the revenue increases and/or spending decreases will need to be to return the Government to a sustainable fiscal path.

While this *Report's* projections of expenditures and receipts under current policy are highly uncertain, current policy cannot be sustained indefinitely.

These and other issues concerning fiscal sustainability are discussed in further detail in the Required Supplementary 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. The Statement of Social Insurance (SOSI) provides a more focused perspective of the Government's "social insurance" programs: Social Security, Medicare, Railroad Retirement, and Black Lung. For these programs, the 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 Required Supplementary Information section 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 Required Supplementary Information section of this *Report*).

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

Dollars in Billions	2012	2011	Increase / (Decrease) $	%
Open Group (Net):				
Social Security (OASDI)	$ (11,278)	$ (9,157)	$ 2,121	23%
Medicare (Parts A, B, & D)	$ (27,174)	$ (24,572)	$ 2,602	11%
Other	$ (102)	$ (101)	$ 1	1%
Total Social Insurance Expenditures, Net (Open Group)	**$ (38,554)**	**$ (33,830)**	$ 4,724	14%
Total Social Insurance Expenditures, Net (Closed Group)	**$ (51,604)**	**$ (46,272)**	$ 5,332	12%
Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)*				
Open Group				
Social Security (OASDI)	-1.2%	-1.0%		
Medicare (Parts A, B, & D)	-3.0%	-2.8%		
Other	0.0%	0.0%		
Total (Open Group)	**-4.2%**	**-3.8%**		
Total (Closed Group)	**-5.6%**	**-5.3%**		

Source: Statement of Social Insurance (SOSI). Amounts equal estimated present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain 'Social Insurance' programs (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 used are from the 2012 & 2011 Social Security and Medicare Trustees Reports and 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.

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. [28]

Table 8 on the previous page summarizes amounts reported in the SOSI, showing that net social insurance expenditures are projected to be $38.6 trillion as of January 1, 2012 for the "Open Group," an increase of $4.8 trillion over net expenditures of $33.8 trillion projected in the 2011 Report.[29] Table 9 summarizes the principal reasons for the changes in projected social insurance amounts during 2012 and 2011. Most of the change from the past year is attributable to the change in the valuation period, and economic data and assumptions (e.g., health care costs, taxable earnings, price inflation, and real interest rates). For both the Old-Age, Survivors, and Disability Insurance (OASDI or Social Security) programs administered by the Social Security Administration (SSA), and the Medicare Part A (Hospital Insurance) program, administered by the Department of Health and Human Services (HHS) , as of the current valuation period (January 1, 2011 – January 1, 2012): (1) taxable earnings are lower for the starting year than projected for the prior valuation period; (2) price inflation was higher than expected, with the cost of living adjustment in December 2011 being higher than assumed in the prior valuation, and (3) the real interest rate is projected to be lower over the first ten years. These changes decrease the present value of future cashflows.[30] The effects of these changes on HHS are reported separately in Table 9 as HHS also includes the effect of specific healthcare assumptions in this category, including but not limited to anticipated effects of the ACA, and growth assumptions for inpatient hospitals and hospice services.

Table 9: Changes in Social Insurance Projections

Dollars in Billions	2012	2011
Net Present Value (NPV) - Open Group (Beginning of the Year)	**$ (33,830)**	**(30,857)**
Change In:		
Valuation Period	$ (1,613)	$ (1,518)
Demographic data and assumptions	$ 518	$ (859)
Economic data and assumptions	$ (1,039)	$ (145)
Law or policy	$ 193	$ (14)
Methodology and programmatic data	$ (471)	$ 56
Economic and other healthcare assumptions[1]	$ (2,601)	$ (463)
Change in projection base	$ 289	$ (31)
Net Change in Open Group measure	$ (4,724)	$ (2,974)
NPV - Open Group (End of the Year)	**$ (38,554)**	**$ (33,830)**

[1] Reported by HHS.

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

As was reported in the FY 2011and 2010 Reports, projected Medicare costs declined significantly reflecting provisions of the ACA. As reported in Note 26, there continues to be 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. Note 26 includes an alternative projection to illustrate the uncertainty of projected Medicare costs. As indicated earlier, GAO disclaimed opinions on the 2012, 2011 and 2010 SOSI because of these significant uncertainties.

Costs as a percent of GDP of both Medicare and Social Security, which are analyzed annually in the Medicare and Social Security Trustees' Reports, are projected to increase substantially through 2035, because: (1) the number of beneficiaries rises rapidly as the "baby-boom" generation retires; and (2) the lower birth rates that have persisted since the baby boom cause slower growth in the labor force and GDP.[31] 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 6.7 percent in 2086 (based on the Trustees intermediate set of assumptions). The Hospital Insurance (HI) Trust Fund is now expected to remain solvent until 2024, (no change from last year's report), at which point tax income is estimated to be sufficient to pay 87 percent of estimated HI costs, declining to 69 percent by 2086.

As for Social Security, combined spending is projected to increase gradually from its current level of 5.0 percent of GDP to about 6.4 percent in 2035, declining to about 6.1 percent by 2055 and remains at about that level

[28] See also Note 28 – Subsequent Events – of this *Report*.

[29] '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 Required Supplementary Information section in this *Report* for more information.

[30] FY 2012 HHS Agency Financial Report p. 119, FY 2012 SSA Performance and Accountability Report, p. 142.

[31] 2012 Annual Trustees Reports on Social Security and Medicare (Summary), p. 2.

through 2086. The Social Security Trustees' Report indicates that annual OASDI income, including interest on trust fund assets, will exceed annual cost and trust fund assets will increase every year until 2021, 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 2033, three years earlier than estimated in the prior year's Trustees' Report, at which point continuing tax income would be sufficient to pay 75 percent of scheduled benefits in 2033 and 73 percent in 2086.[32]

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 Required Supplementary 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. The number of CFO Act agencies reporting non-compliance with one or more of the Federal Financial Management Improvement Act (FFMIA) requirements in FY 2012 was 9, compared to 7 in FY 2011, and the number of auditors reporting non-compliance with one or more of the FFMIA requirements was 11 in both FY 2012 and FY 2011. 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 controls. 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.

The total number of material weaknesses for Chief Financial Officers (CFO) Act agencies increased to 32, compared to 31 in FY 2011. 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.

[32] 2012 Annual Trustees Reports on Social Security and Medicare (Summary), pp. 2,9-10.

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, 23 of the 24 CFO Act agencies obtained an opinion from the independent auditors on their financial statements.[33] Out of the 24 major "CFO Act" agencies, there were 21 clean opinions, 2 qualified opinions, and only one remaining disclaimer in FY 2012. In addition, 32 auditor-identified material weaknesses were reported in FY 2012, an approximate 50 percent decline from the 61 material weaknesses that were identified at the start of this past decade. 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. However, 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 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 our progress, critical gaps in financial management performance remain. For example, Federal agencies continue to maintain thousands of unneeded real property assets on their books, reported approximately $108 billion in estimated improper payments in FY 2012, and continue to incur increased costs to modernize agency financial systems. Additionally, 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. 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

Today, accountability means providing transparent information to the public about where and how Federal dollars are being spent. It means protecting against fraud. It means avoiding wasteful or excessive use of taxpayer funds. It means ensuring that we are not only responsible stewards of taxpayer dollars, but frugal stewards as well, looking for every opportunity to save money and create greater efficiencies.

[33] 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.

Administrative Savings

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 (EO) 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 EO 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. In addition, a key focus of the Campaign has been reducing government travel and conference spending as highlighted through OMB Memorandum 12-12 "Promoting Efficient Spending to Support Agency Operations." Underlying the Administration's dedication to ensure taxpayer money is spent prudently and effectively, many of the innovate management practices highlighted through the Campaign to Cut Waste were included in the President's FY 2013 budget sent to Congress. 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. In June 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. As of the first quarter of 2012, Federal agencies have identified $2.4 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. In addition, in an effort to spur innovation and further improve the management of Federal real property, OMB issued Memorandum 12-12 "Promoting Efficient Spending to Support Agency Operations". This Memorandum prohibits the increase of agency civilian real property inventory, unless certain exclusions apply. This policy will enable the Federal Government to continue making progress on real property management by encouraging smarter use of building space and requiring an agency-wide assessment of newly-acquired space.

To further build on this effort and work in achieving more long-term savings, the President introduced the Civilian Property Realignment Act in the FY 2013 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 three 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. The Do Not Pay program opened for business last spring. The Do Not Pay is run by the Department of the Treasury and allows agencies to perform data matching by reviewing multiple databases to determine a recipient's award or payment eligibility. A Data Analytics Service has been developed, in addition to the data-matching service, to provide customized matching and analysis of an agency's payment file to identify irregularities and fraud. The Treasury Department is also developing new data analytic approaches to assess the relative risk level of those who are identified as suspect through the Do Not Pay tool and working to standardize disbursement data, making it easier to perform computer matching and trend analysis.

While agencies are continuing to implement these initiatives, we are already seeing real results. Based on information submitted by agencies in FY 2012, the reported government-wide error rate is 4.35 percent, a decrease from the FY 2011 rate of 4.69 percent, and we have successfully reduced error rates in major programs, such as Medicare Fee-for-Service; Medicaid; Unemployment Insurance (UI); the Earned Income Tax Credit; Supplemental Nutrition Assistance Program (SNAP—Food Stamps); Pell Grants; the School Lunch program; and Old Age, Survivors, and Disability Insurance. If the FY 2009 rate of 5.4 percent had been in effect in FY 2010, 2011, and 2012, the Government would have reported in total $47 billion more in estimated improper payments during the three-year period. This figure can be compared with the President's ambitious goal of reducing improper payments during the same period by $50 billion. In addition, agencies reported recapturing more than $2.4 billion in improper payments to contractors and vendors in FY 2012, almost twice as much as was recaptured in FY 2011.

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, nine pilots have been funded and are being implemented by lead Federal agencies in cooperation with state partners. These pilots address multiple programs, including the SNAP, Unemployment Insurance, Medicaid, the Earned Income Tax Credit (EITC), and the Treasury Offset Program, as well as other human services and juvenile justice programs. Early pilot results are expected in FY 2013.

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. As a result, 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. OMB is committed to reshaping its approach to modernizing financial systems and will continue to work with the agencies to find smarter practices in modernization. During FY 2012, OMB and Treasury partnered to develop a performance-based approach to assessing compliance with the Federal Financial Management Improvement Act and revise financial management system requirements to emphasize the Federal government's financial management business needs. OMB plans to implement an outcome-based approach and revised system requirements in FY 2013. Moving forward in FY 2013, to meet agencies' long-term financial management needs, OMB and Treasury will work with external service providers to enhance service offerings, expand technology and transaction processing capabilities, and build a strong governance structure to achieve cost savings and reduce risks in financial system modernization efforts.

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. As part of the Administration's Campaign to Cut Waste, the President issued Executive Order (EO) 13576, "Delivering an Efficient, Effective, and Accountable Government," establishing the Government Accountability and Transparency Board (GATB) in June 2011. 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, leveraging the experience and lessons learned from the implementation of the Recovery Act and the Recovery Accountability and Transparency Board (RATB).

The Administration issued Memorandum 10-26 "Open Government Directive," 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, 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. 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 improve reliability of existing data. Approaches that may be explored include, but are not limited to the use of control totals, such as through validation against award documents and/or using data from financial systems. Efforts such as these could improve the quality of Federal spending information to promote accountability and ultimately to improve the performance of Federal programs.

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. In February 2012, OMB published an Advance Notice of Proposed Guidance discussing possible policy changes to meet the President's February 2011 directive that OMB will work with Federal and non-Federal stakeholders to review OMB Circulars and look for ways to better target risk and reduce administrative burden for recipients while improving program outcomes for Federal grants. In November 2012, the Council on Financial Assistance Reform (COFAR) approved a set of five priority goals for fiscal years 2012-2015. These include implementing revised guidance to target risk and reduce administrative burden per the directive above, standardizing business processes to streamline data collections, providing the public with validated financial data that aligns spending information with core financial accounting data in coordination with the work of the GATB, ensuring that grants professionals are highly qualified, and providing strong program oversight that increases the number of clean, single-audit opinions for grant recipients. The COFAR was created in October 2011, when OMB issued Memorandum12-01, "Creation of the Council on Financial Assistance Reform " to provide policy-level leadership for the grants community to implement much needed reforms to improve effectiveness and efficiency in Federal grants.

Conclusion

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 4.69 percent in FY 2011 to 4.35 percent in FY 2012, and nearly doubling the amount of recaptured overpayments to contractors and vendors. 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 *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 *Report* can be found in these entities' financial statements included in their Performance and Accountability and Annual Financial Reports. This *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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