



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

**A Message from the Secretary of the Treasury**

The Financial Report of the U.S. Government for Fiscal Year 2012 is a comprehensive look at the government's financial condition and an important tool for understanding how we continue to move forward and meet our fiscal challenges. These challenges, including the lingering effects of the financial crisis, are significant, but the President and Congress have taken important steps to bolster economic growth, revive the health of the financial system, and restore fiscal sustainability.

The President and Congress enacted significant fiscal reforms in the Budget Control Act of 2011, including more than \$1 trillion in spending cuts. More recently, the President signed into law a set of revenue measures that permanently extended tax cuts for the middle class while letting tax rates increase modestly on the wealthiest Americans. This will help raise hundreds of billions of dollars over the next 10 years. The President and Congress will continue to work to reduce future budget deficits. In addition to these changes, the Affordable Care Act of 2009 is projected to substantially reduce the cost of providing health care for seniors, to provide more Americans with access to health care, and to reduce the nation's debt.

Our current fiscal challenges are not, of course, the only economic obstacle facing the United States. While the economy has expanded and businesses are investing and hiring, our efforts must continue to strengthen growth long into the future. This will require economic policies that protect middle-class families, promote retirement security, and reduce the deficit in a balanced fashion in order to preserve room for the investments that spur economic growth.

Timothy F. Geithner

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**CITIZEN'S GUIDE TO THE  
2012 FINANCIAL REPORT OF THE UNITED STATES  
GOVERNMENT**

## A Citizen's Guide to the Fiscal Year 2012 Financial Report of the United States Government

The Citizen's Guide (Guide) to the Fiscal Year (FY) 2012 Financial Report of the U.S. Government summarizes the current financial position and condition of the U.S. Government (See "Where We Are Now", p. ii) and discusses key financial topics, including fiscal sustainability (See "Where We Are Headed", p. v). This Guide and the Financial Report of the U.S. Government are produced by the U.S. Department of the Treasury in cooperation with the Office of Management and Budget (OMB). The Secretary of the Treasury, Deputy Director for Management of OMB, and Comptroller General of the United States at the Government Accountability Office (GAO) believe that the information discussed in this Guide is important to all Americans.

### Where We Are Now

#### Comparing the Budget and the Financial Report

The *Budget of the United States Government* (Budget) is the Government's primary financial planning and control tool. It accounts for past Government receipts and spending, and presents the President's proposed receipt and spending plan. The Budget compares *receipts*, or cash received by the Government, with *outlays*, or payments made by the Government to the public, to derive a budget *surplus* (excess of receipts over outlays) or *deficit* (excess of outlays over receipts). Receipts and outlays are measured generally based on when the Government receives or dispenses cash.

The *Financial Report of the United States Government* (Report) focuses on the Government's revenues and costs (what came in and what went out), assets and liabilities (what it owns and owes), and other important financial information. It compares *revenues* (what the Government has collected and expects to collect, but has not necessarily received), with its *costs* (what the Government has incurred, but has not necessarily paid) to derive net operating cost.

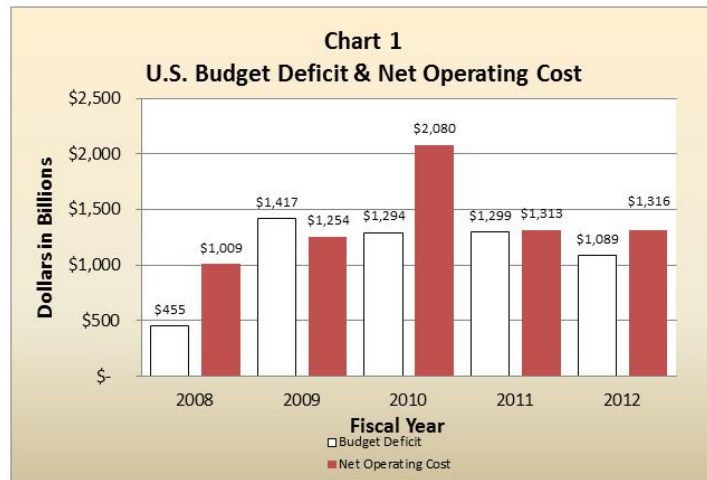
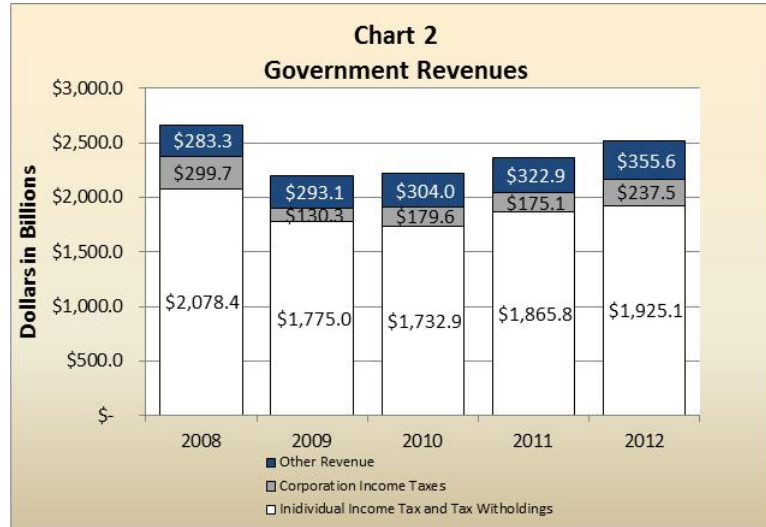


Chart 1 compares the Government's budget deficit and net operating cost for FY 2008-2012. The difference between the \$1.1 trillion budget deficit and \$1.3 trillion net operating cost in FY 2012 is predominantly due to: (1) non-cash costs associated with an increase in estimated liabilities related to Federal employee and veteran benefits, and (2) a partially offsetting decrease in costs associated with lower projected liabilities to the Government-Sponsored Enterprises (GSEs), specifically Fannie Mae and Freddie Mac. Together, the Budget and the Report present complementary perspectives on the Government's financial position and condition, and provide a valuable decision-making and management tool for the Nation's leaders.



## What Came In and What Went Out

What came in? Chart 2 shows that increases in each of the three revenue categories (individual income tax and withholdings, corporate income taxes, and other revenue) combined to increase total Government revenues by \$154.4 billion (6.5 percent) to just over \$2.5 trillion for FY 2012. Together, individual and corporate taxes accounted for about 86 percent of total revenues. Other revenues include excise and unemployment taxes, and customs duties.



What went out? The Government derives its net cost (\$3.8 trillion in FY 2012) by subtracting revenues earned from Government programs (e.g., Medicare premiums, National park entry fees, and postal fees) from its gross costs and adjusts the amount for gains or losses from changes in actuarial assumptions used to estimate future liabilities for Federal employee and veteran benefits. The Government deducts taxes and other revenues shown in Chart 2, as well as adjustments for unmatched transactions and balances, from its net cost to arrive at its “bottom line” net operating cost, which increased by \$3.7 billion (less than one-half of one percent), to remain essentially unchanged at \$1.3 trillion in FY 2012. However, this minimal change includes significant offsetting changes, primarily: (1) a \$292.1 billion increase in certain cost estimates for federal employee and veteran benefits; and (2) a \$288.7 billion cost decrease<sup>1</sup> associated with changes in Government liabilities to the GSEs.

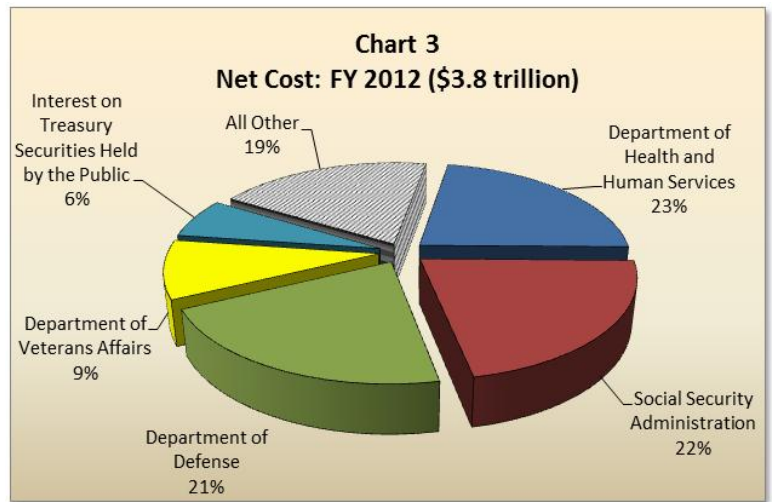


Chart 3 shows that the largest contributors to the Government’s net cost in FY 2012, as is the case in most years, include the Departments of Health and Human Services (HHS) and Defense (DoD) and the Social Security Administration (SSA). The bulk of HHS and SSA costs come from major social insurance and postemployment benefits programs administered by those agencies (e.g., Medicare for HHS, and Social Security for SSA). While much of DoD’s total costs relate to military operations and personnel, most of the increase in DoD’s cost during FY 2012 was attributed to its Military Retirement Fund and other benefits programs.

<sup>1</sup> [Department of the Treasury’s FY 2012 Annual Financial Report](#), p. 101.

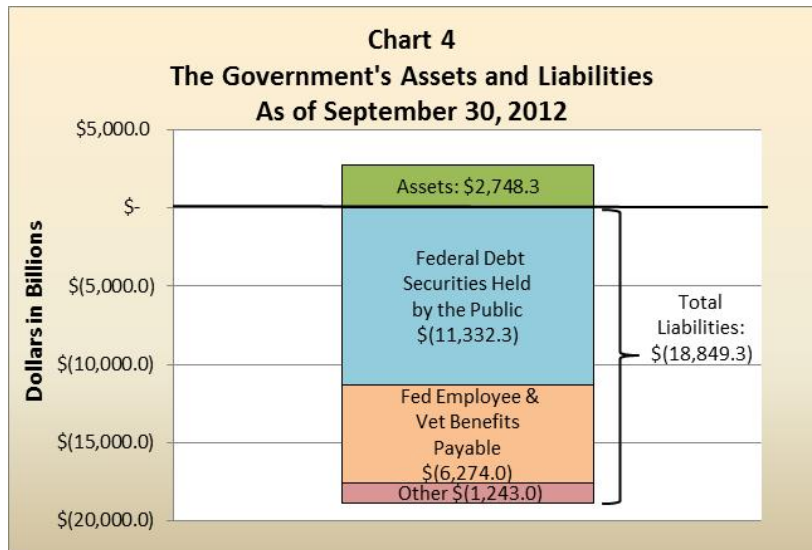
## What We Own and What We Owe

Chart 4 is a summary of what the Government owns in assets and what it owes in liabilities. As of September 30, 2012, the Government held about \$2.7 trillion in assets, comprised mostly of net property, plant, and equipment (\$855.0 billion) and a combined total of \$1,009.1 billion in net loans receivable (e.g., student loans) and direct loans and investments associated with the Troubled Asset Relief Program (TARP) and the GSEs (which relate to the Government's

economic recovery efforts). In recent years, with the ongoing wind-down of these programs, the balances of many of these investments have declined primarily through repayments and sales. 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.

The \$18.8 trillion in total liabilities is comprised mostly of: (1) \$11.3 trillion in Federal debt securities held by the public and accrued interest<sup>2</sup> and (2) \$6.3 trillion in Federal employee and veteran benefits payable. The Government also reports about \$4.9 trillion of intragovernmental debt outstanding, which arises when one part of the Government borrows from another. For example, Government funds (e.g., Social Security and Medicare trust funds) are typically required to invest excess annual receipts in Federal debt securities issued by the Treasury Department, thus creating liabilities of the Treasury and assets of the trust funds. These respective amounts are included in individual Treasury Department and investing agency financial statements, but offset each other when the Governmentwide consolidated financial statements are prepared.

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), which was most recently raised by \$1.2 trillion to \$16.394 trillion in January 2012 pursuant to the Budget Control Act (BCA) of 2011. As of September 30, 2012, the Government's total debt outstanding subject to the debt limit was \$16.027 trillion, \$367 billion below the current limit. As budget deficits continue to occur, the Government will have to borrow more from the public. Instances where the debt held by the public increases faster than the economy<sup>3</sup> for extended periods can pose additional challenges.



<sup>2</sup> Debt held by the public and accrued interest, as reported on the Government's balance sheet, primarily consists of Treasury securities, net of unamortized discounts and premiums, and accrued interest. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the Federal Government.

<sup>3</sup> Considering key macroeconomic indicators can help place the discussion of the Government's financial results in a broader context. During FY 2012, the economy continued to grow, and at a faster rate than the previous year, job creation accelerated, and the unemployment rate declined. These and other economic and financial developments are discussed in greater detail in the *Report*.

## Where We Are Headed

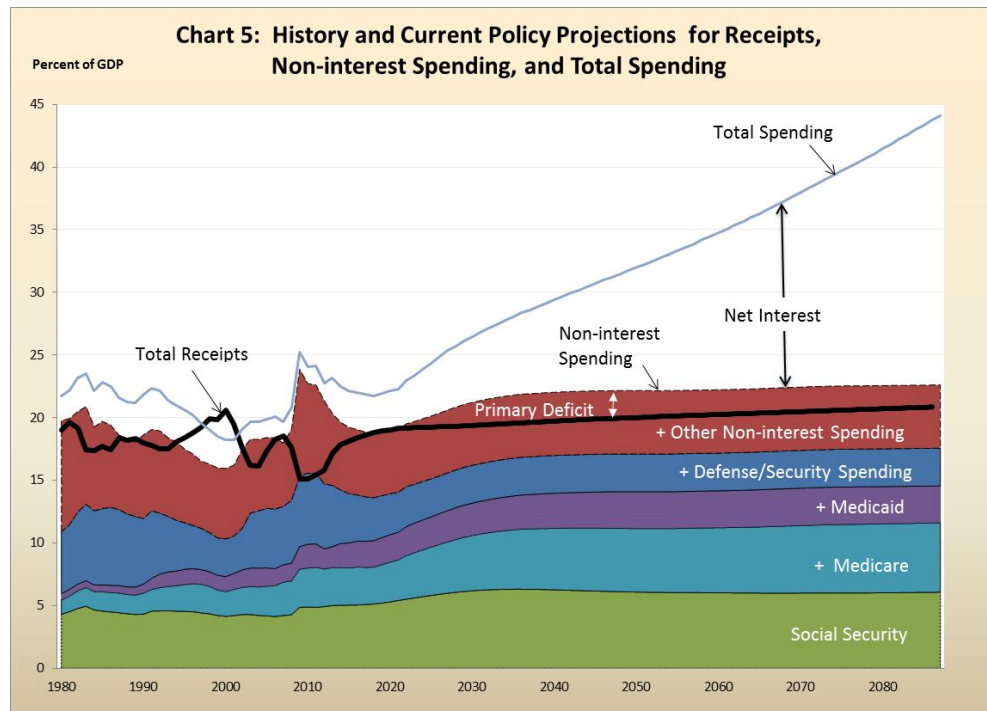
An important purpose of this Guide and the *Report* is to help citizens understand current fiscal policy, and the importance and magnitude of policy reforms necessary to make it sustainable. A sustainable policy is one where the ratio of debt held by the public to Gross Domestic Product (GDP) (the debt-to-GDP ratio) is ultimately stable or declining. To determine if current fiscal policy is sustainable, the projections discussed in this Guide assume current policy will be sustained indefinitely and draw out the implications for the growth of the debt-to-GDP ratio.<sup>4</sup> 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.<sup>5</sup>

### Receipts, Spending, and the Debt

Chart 5 shows historical and current policy projections for receipts, non-interest spending by major category, and total spending expressed as a percent of GDP. The difference between the

receipts and non-interest spending shares of GDP - 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 BCA take effect, reaching primary balance in 2018, and remaining relatively flat and near zero until 2021. Between 2022 and 2039, however, increased spending for Social Security and health

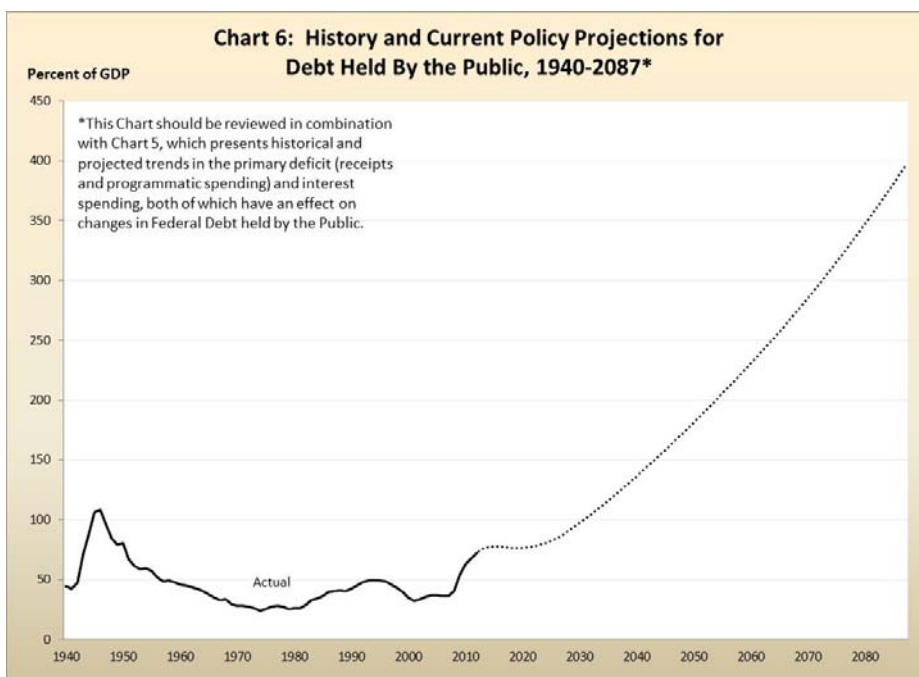
<sup>4</sup> Current policy in the projections is based on current law, but includes extension of certain policies that expire under current law but are routinely extended or otherwise expected to continue, such as extension of relief from the Alternative Minimum Tax (AMT). In addition, for this year's *Report*, the projections include the extension of all 2001/2003 tax cuts indefinitely, whereas in the FY 2011 *Report*, it was assumed that the high income tax cuts were allowed to expire.

<sup>5</sup> 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.

programs<sup>6</sup> due to continued aging of the population and anticipated rising health costs is expected to cause the primary deficit-to-GDP ratio to steadily deteriorate, reaching 2.3 percent of GDP in 2039. After 2039, the ratio is projected to slowly decline to 1.7 percent of GDP in 2087 as the impact of the baby boom generation retiring dissipates. In these projections, the Affordable Care Act (ACA)<sup>7</sup> provision of health insurance subsidies and expanded Medicaid coverage boost federal spending, and other provisions significantly reduce per-beneficiary Medicare and Medicaid cost growth. Overall, the ACA is projected to substantially reduce federal expenditures over the next 75 years. However, as noted in the *Report*, there is uncertainty about the effectiveness of the ACA's provisions designed to reduce health care cost growth. Even if those provisions work as intended and as assumed in these projections, Chart 5 still shows a persistent gap between projected receipts and total non-interest spending.

The primary deficit projections in Chart 5, along with those for interest rates and GDP, determine the debt-to-GDP ratio projections shown in Chart 6.

That ratio was 73 percent at the end of FY 2012 and under current policy is projected to grow to 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.



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

It is estimated that preventing the debt-to-GDP ratio from rising over the next 75 years would require some combination of expenditure reductions and revenue increases that amount, on average, to 2.7 percent of GDP over each of the next 75 years. The timing of changes to non-interest spending and receipts that close this “75-year fiscal gap” has important implications for the well-being of future generations. For example, relative to a policy that begins immediately, it

<sup>6</sup> The 2012 Medicare Trustees Report projects that, assuming full implementation of the Affordable Care Act (ACA) provisions, the Hospital Insurance (HI) Trust Fund will remain solvent under current law until 2024, at which point the share of estimated HI costs that could be paid from trust fund income is 87 percent, declining to 69 percent by 2086. As for Social Security, under current law, the Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds are projected to be exhausted in 2033, at which time the projected share of scheduled benefits payable from trust fund income is 75 percent, declining to 73 percent in 2086. The projections assume full Social Security and Medicare benefits are paid after the corresponding trust funds are exhausted. See <http://www.ssa.gov/oact/trsum/index.html>.

<sup>7</sup> The ACA refers to [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 significantly reduces Medicare payment rates.

is estimated that the magnitude of reforms necessary to close the 75-year fiscal gap increases by nearly 20 percent if action is delayed by 10-years and for more than 50 percent if action is delayed 20 years.

## Conclusion

The Government took potentially significant steps towards fiscal sustainability by enacting: (1) the ACA in 2010 and (2) the BCA in 2011. The ACA holds the prospect of lowering the 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 these new laws, the Government's debt-to-GDP ratio is projected to increase continuously over the next 75 years and beyond if current policy is kept in place, which implies that current policy is not sustainable. Subject to the important caveat that changes in policy not be 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.<sup>8</sup>

## The Nation By The Numbers

The *Report* provides the President, Congress, and the American people a comprehensive view of how the Government is managing taxpayer dollars. It discusses the Government's financial position and condition, its revenues and costs, assets and liabilities, and other responsibilities and commitments, as well as important financial issues that affect the Nation and its citizens both now and in the future. The table on the following page presents several key indicators of the Government's financial position and condition, which are summarized in this Guide and discussed in greater detail in the *Report*.

The Government Accountability Office's (GAO) audit report on the U.S. Government's consolidated financial statements can be found beginning on page 223 of the full *Report*. GAO disclaimed an opinion on the 2012, 2011, and 2010 Statements of Social Insurance (SOSI) and the 2012 and 2011 Statements of Changes in Social Insurance Amounts because of significant uncertainties (discussed in Note 26 in the *Report*) primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 SOSI. However, GAO issued an unqualified or "clean" opinion on the 2009 and 2008 SOSI.<sup>9</sup> In addition, certain material financial reporting control weaknesses and other limitations on the scope of its work prevented GAO from expressing an opinion on the remaining FY 2012 and 2011 financial statements in the *Report*.

<sup>8</sup> Further information about these fiscal projections and the underlying assumptions can be found in the Required Supplementary Information section of the Financial Report at [www.fms.treas.gov/fr](http://www.fms.treas.gov/fr).

<sup>9</sup> In conformity with Federal accounting standards, Statements of Social Insurance are presented for the current year and each of the four preceding years.

<b>NATION BY THE NUMBERS</b>		
<b>A Snapshot of The Government's Financial Position &amp; Condition</b>		
billions of dollars	2012	2011
<b>Gross Costs</b>	<b>\$ (3,844.9)</b>	<b>\$ (3,998.3)</b>
Less: Earned Revenues	\$ 350.8	\$ 365.6
Gain/(Loss) from Changes in Assumptions	\$ (320.2)	\$ (28.1)
<b>Net Cost</b>	<b>\$ (3,814.3)</b>	<b>\$ (3,660.8)</b>
<b>Less: Total Taxes and Other Revenues</b>	<b>\$ 2,518.2</b>	<b>\$ 2,363.8</b>
Unmatched Transactions and Balances	\$ (20.2)	\$ (15.6)
<b>Net Operating Cost</b>	<b>\$ (1,316.3)</b>	<b>\$ (1,312.6)</b>
<b>Assets:</b>	<b>\$ 2,748.3</b>	<b>\$ 2,707.3</b>
<b>Less: Liabilities, comprised of:</b>		
Debt Held By the Public & Accrued Interest	\$ (11,332.3)	\$ (10,174.1)
Federal Employee & Veteran Benefits	\$ (6,274.0)	\$ (5,792.2)
Other	\$ (1,243.0)	\$ (1,526.4)
<b>Total Liabilities</b>	<b>\$ (18,849.3)</b>	<b>\$ (17,492.7)</b>
<b>Net Position (Assets Minus Liabilities)</b>	<b>\$ (16,101.0)</b>	<b>\$ (14,785.4)</b>
<b>Sustainability Measures:</b>		
Social Insurance Net Expenditures <sup>1</sup>	\$ (38,554)	\$ (33,830)
Total Non-Interest Net Expenditures <sup>2</sup>	\$ (16,500)	\$ (6,400)
<b>Sustainability Measures as Percent of Gross Domestic Product (GDP):</b>		
Social Insurance Net Expenditures <sup>3</sup>	-4.2%	-3.8%
Total Federal Government Non-Interest Net Expenditures	-1.7%	-0.7%
<b>Budget Results</b>		
<b>Unified Budget Deficit</b>	<b>\$ (1,089.4)</b>	<b>\$ (1,298.6)</b>

1 Source: Statement of Social Insurance. Amounts equal present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain benefit programs that are referred to as Social Insurance (e.g., Social Security, Medicare). Amounts represent 'open group' population (all current and future beneficiaries). These amounts are not considered liabilities on the balance sheet.

2 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 Financial Report of the U.S. Government.

3 GDP values used represent the average of 75-year present value of nominal GDP for 2012 and 2011 from the Social Security and Medicare Trustees Reports.

## Find Out More

The 2012 Financial Report of the United States Government and other information about the Nation's finances are available at:

- U.S. Department of the Treasury, <http://www.fms.treas.gov/fr.html>;
- OMB's Office of Federal Financial Management, <http://www.whitehouse.gov/omb/financial/index.html>; and
- GAO, <http://www.gao.gov/financial.html>.

# 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<sup>1</sup> of the 35 most significant agencies earned unqualified opinions on their financial statement audits.<sup>2</sup>

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

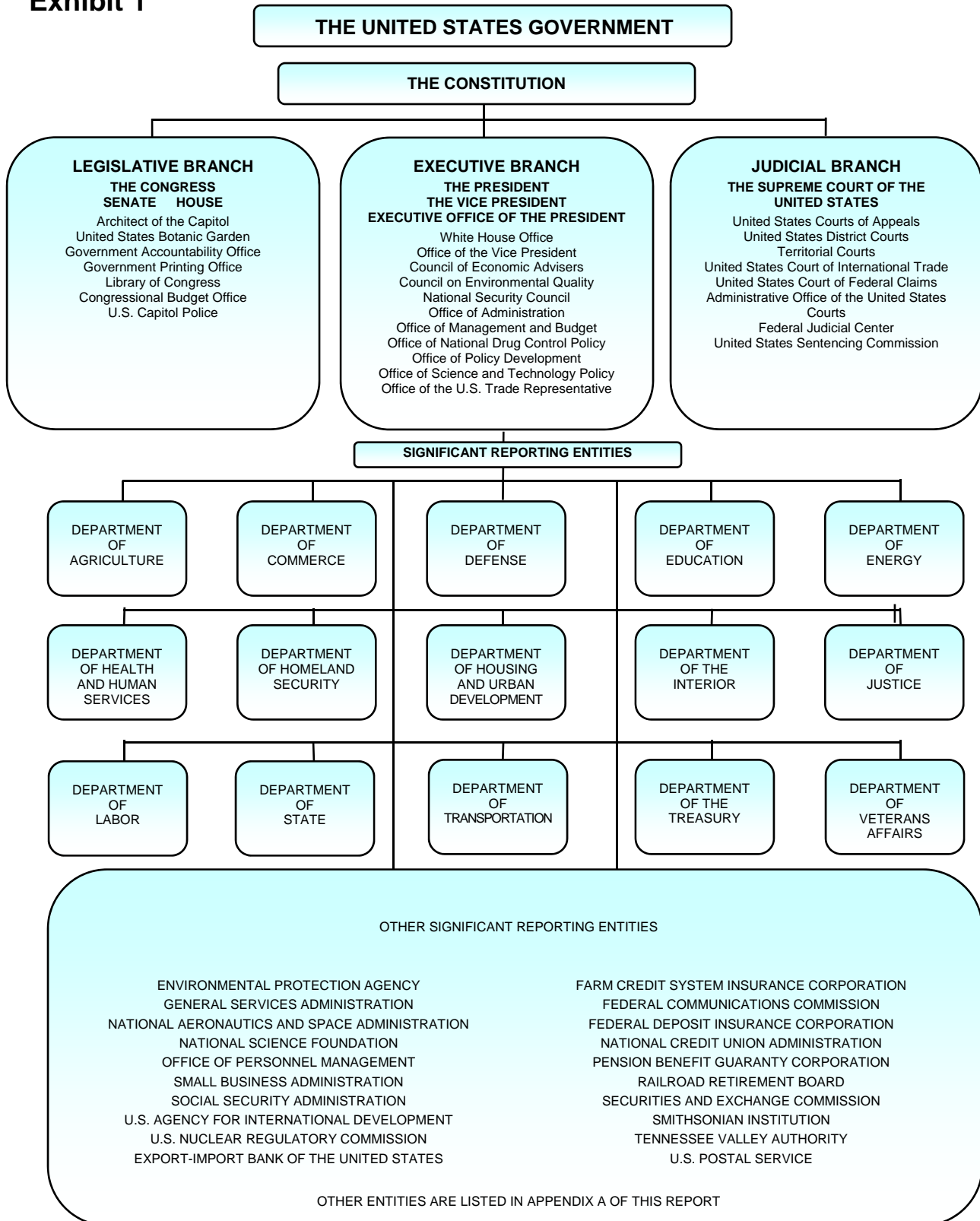
The Government's fundamental mission is derived from the Constitution: "...to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity." The Congress authorizes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

<sup>1</sup> 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.

<sup>2</sup> 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.

Dollars in Billions	2012	2011	Increase / (Decrease)	
			\$	%
<b>FINANCIAL MEASURES</b>				
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%
<b>Net Cost<sup>1</sup></b>	<b>\$ (3,814.3)</b>	<b>\$ (3,660.8)</b>	<b>\$ 153.5</b>	<b>4.2%</b>
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%
<b>Net Operating Cost<sup>2</sup></b>	<b>\$ (1,316.3)</b>	<b>\$ (1,312.6)</b>	<b>\$ 3.7</b>	<b>0.3%</b>
<b>Assets<sup>3</sup>:</b>				
Cash & Other Monetary Assets	\$ 206.2	\$ 177.0	\$ 29.2	16.5%
Loans Receivable and Investments, Net <sup>4</sup>	\$ 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%)
<b>Total Assets</b>	<b>\$ 2,748.3</b>	<b>\$ 2,707.3</b>	<b>\$ 41.0</b>	<b>1.5%</b>
<b>Liabilities<sup>3</sup>:</b>				
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%)
<b>Total Liabilities</b>	<b>\$ (18,849.3)</b>	<b>\$ (17,492.7)</b>	<b>\$ 1,356.6</b>	<b>7.8%</b>
<b>Net Position (Assets minus Liabilities)</b>	<b>\$ (16,101.0)</b>	<b>\$ (14,785.4)</b>	<b>\$ (1,315.6)</b>	<b>(8.9%)</b>
<b>SUSTAINABILITY MEASURES</b>				
<b>Social Insurance Net Expenditures<sup>5</sup>:</b>				
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%
<b>Total Social Insurance Net Expenditures</b>	<b>\$ (38,554)</b>	<b>\$ (33,830)</b>	<b>\$ 4,724</b>	<b>14.0%</b>
<b>Total Federal Government Noninterest Net Expenditures<sup>6</sup></b>	<b>\$ (16,500)</b>	<b>\$ (6,400)</b>	<b>\$ 10,100</b>	<b>157.8%</b>
<b>BUDGET DEFICIT</b>				
<b>Unified Budget Deficit<sup>7</sup></b>	<b>\$ (1,089.4)</b>	<b>\$ (1,298.6)</b>	<b>\$ (209.2)</b>	<b>(16.1%)</b>

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<sup>3</sup> 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<sup>4</sup> to a subset of the revenues<sup>5</sup> 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.<sup>6</sup>
- 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.

<sup>3</sup> 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.

<sup>4</sup> The Black Lung Program is projected through September 30, 2040.

<sup>5</sup> 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.

<sup>6</sup> [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)<sup>7</sup>.

### 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

**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) <sup>1</sup>	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 Corporation (FCSIC) <sup>2</sup>	Unqualified
Federal Communications Commission (FCC)	Unqualified
Federal Deposit Insurance Corporation (FDIC) <sup>2</sup>	Unqualified
National Credit Union Administration (NCUA) <sup>2</sup>	Unqualified
Pension Benefit Guaranty Corporation (PBGC)	Unqualified
Railroad Retirement Board (RRB)	Disclaimer
Securities and Exchange Commission (SEC)	Unqualified
Smithsonian Institution <sup>3</sup>	Unqualified
Tennessee Valley Authority (TVA)	Unqualified
U.S. Postal Service (USPS)	Unqualified

<sup>1</sup> Received disclaimer of opinion on Statement of Social Insurance and Statement of Changes in Social Insurance Amounts.

<sup>2</sup> Entities operate under calendar year (CY)-end. Opinions reflect CY 2011 audit results.

<sup>3</sup> Opinion on the most recent annual report, covering FY 2011.

<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup> 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*
<p>Prepared primarily on a "<u>cash basis</u>"</p> <ul style="list-style-type: none"> <li>Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them.</li> <li>Receipts ("cash in"), taxes and other collections recorded when received.</li> <li>Outlays ("cash out"), largely recorded when payment is made.</li> </ul>	<p>Prepared on an "<u>accrual and modified cash basis</u>"</p> <ul style="list-style-type: none"> <li>Agency-based and retrospective – prior and present resources used to implement initiatives.</li> <li>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.</li> <li>Costs: recognized when owed, but not necessarily paid.</li> </ul>

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

<sup>8</sup> 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.

<sup>9</sup> 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<sup>10</sup> 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.

Dollars in Billions	2012	2011	Increase / (Decrease)
<b>Net Operating Cost</b>	<b>\$ (1,316.3)</b>	<b>\$ (1,312.6)</b>	<b>\$ 3.7</b>
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
<b>Budget Deficit</b>	<b>\$ (1,089.4)</b>	<b>\$ (1,298.6)</b>	<b>\$ (209.2)</b>

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.

<sup>10</sup> 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.

Dollars in Billions			Increase / (Decrease)	
	2012	2011	\$	%
<b>Gross Cost</b>	\$ (3,844.9)	\$ (3,998.3)	\$ (153.4)	(3.8%)
Less: Earned Revenue <sup>1</sup>	\$ 350.8	\$ 365.6	\$ (14.8)	(4.0%)
<b>Subtotal</b>	\$ (3,494.1)	\$ (3,632.7)	\$ (138.6)	(3.8%)
Gain/(Loss) from Changes in Assumptions <sup>2</sup>	\$ (320.2)	\$ (28.1)	\$ 292.1	1039.5%
<b>Net Cost</b>	\$ (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 <sup>3</sup>	\$ (20.2)	\$ (15.6)	\$ 4.6	29.5%
<b>Net Operating Cost</b>	\$ (1,316.3)	\$ (1,312.6)	\$ 3.7	0.3%

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

<sup>2</sup> Changes in assumptions used to estimate liabilities for federal employee pensions and other retirement and postemployment benefits.

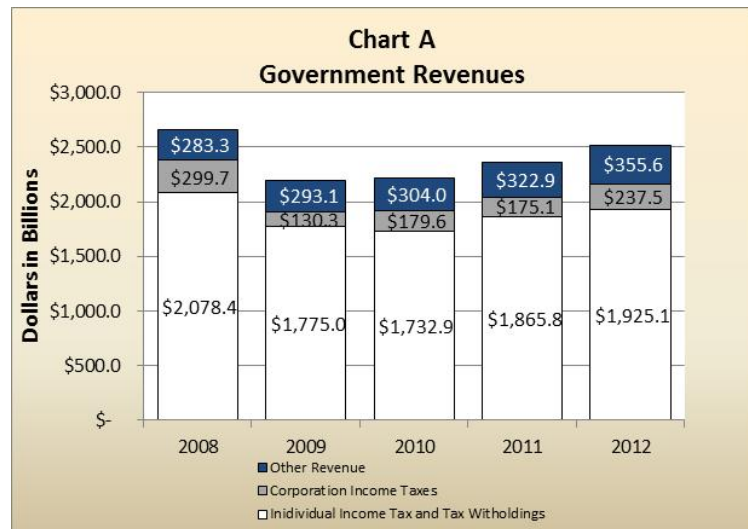
<sup>3</sup> Represents unreconciled differences in intragovernmental activity and balances between Federal agencies.

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.

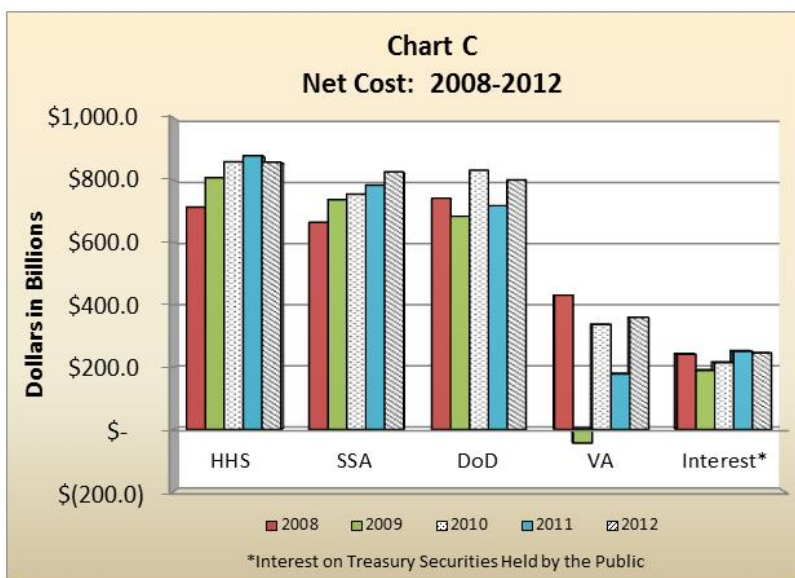
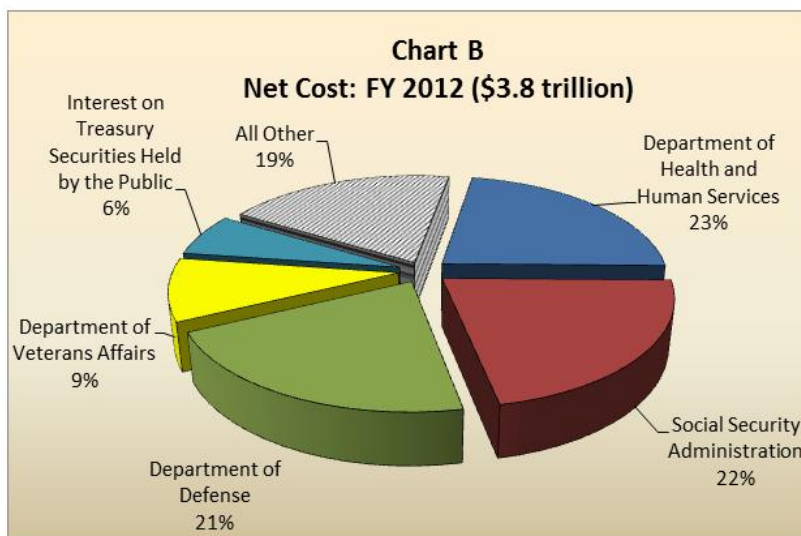


**Cost: “What Went Out”**

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).<sup>11</sup> 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.<sup>12</sup> 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

Net Position Dollars in Billions	2012		2011		Increase (Decrease)	
	\$	%	\$	%	\$	%
<b>Assets</b>						
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%)
<b>Total Assets</b>	<b>\$ 2,748.3</b>		<b>\$ 2,707.3</b>		<b>\$ 41.0</b>	<b>1.5%</b>
<b>Less: Liabilities, comprised of:</b>						
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%)
<b>Total Liabilities</b>	<b>\$ (18,849.3)</b>		<b>\$ (17,492.7)</b>		<b>\$ 1,356.6</b>	<b>7.8%</b>
<b>Net Position (Assets Minus Liabilities)</b>	<b>\$ (16,101.0)</b>		<b>\$ (14,785.4)</b>		<b>\$ (1,315.6)</b>	<b>(8.9%)</b>

\*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).

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

<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup> 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.<sup>15</sup>
- 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.<sup>16</sup>
- 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,<sup>17</sup> and reported that overall, cash returns of \$250 billion were received from the MBS portfolio through sales, principal, and interest.<sup>18</sup>
- 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

<sup>13</sup> [U.S. Department of Education's FY 2012 Agency Financial Report](#), p. 58.

<sup>14</sup> 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.

<sup>15</sup> [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](http://www.financialstability.gov).

<sup>16</sup> [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*.

<sup>17</sup> [Department of the Treasury FY 2012 Agency Financial Report](#), pp. 11, 104.

<sup>18</sup> [Department of the Treasury FY 2012 Agency Financial Report](#), p. 159.

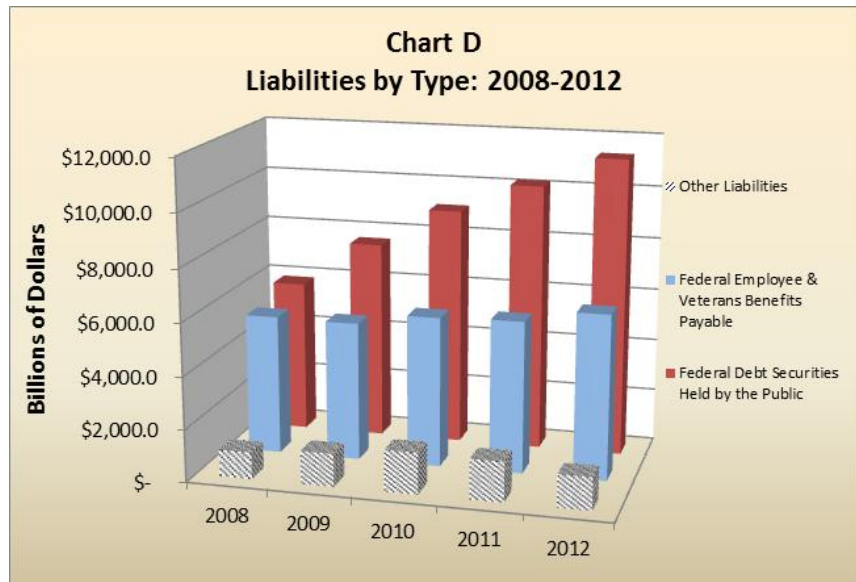
payments due to a change made during FY 2012 to the SPSPA dividend calculation. This change, which commences with the quarter ending March 31, 2013, will lower the amount of funds drawn from Treasury under the SPSPAs, because the GSEs would no longer need to make draws to fund dividend payments to Treasury. 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.<sup>19</sup>

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<sup>20</sup> and 2.5 million annuitants.<sup>21</sup> 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.<sup>22</sup>



### 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

<sup>19</sup> [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.

<sup>20</sup> As of 9/30/2012 OPM Office of Actuaries.

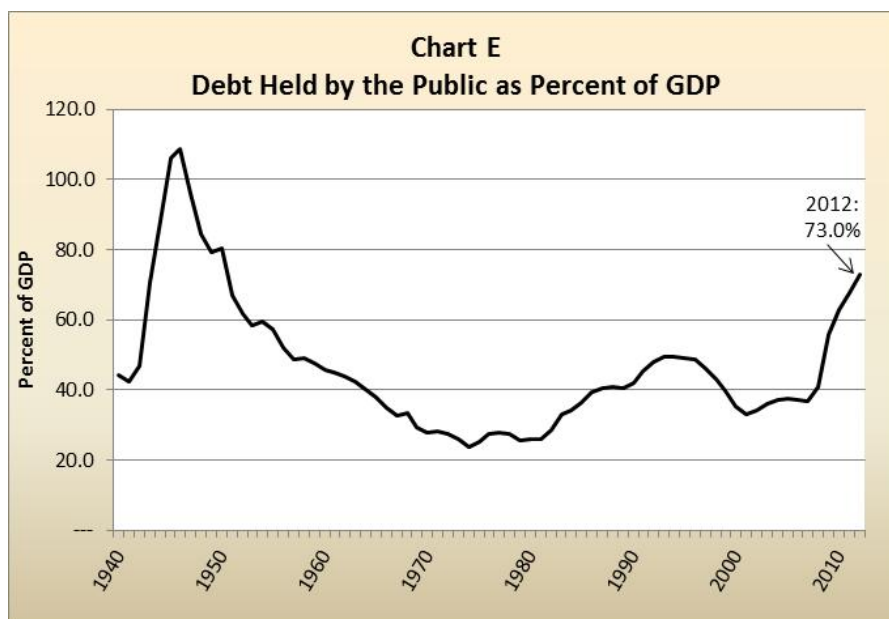
<sup>21</sup> [OPM FY 2012 Agency Financial Report](#), p. 9.

<sup>22</sup> [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.<sup>23</sup>



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

<sup>23</sup> 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.

	<b>FY 2012</b>	<b>FY 2011</b>
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.<sup>24</sup> 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](http://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.

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<sup>24</sup> Agency Financial & Activity Reports as of September 30, 2012 and 2011. For more information, see the Recovery Act website at [www.recovery.gov](http://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.<sup>25</sup> 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.<sup>26</sup>

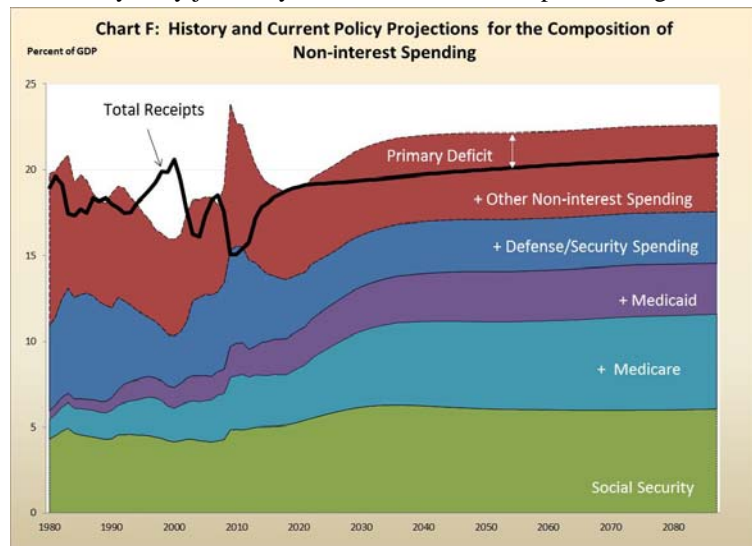
The projections in this *Report* indicate that current policy is not sustainable. The debt-to-GDP ratio is projected to reach 395 percent in 2087 and to rise continuously thereafter. Preventing the debt-to-GDP ratio from rising over the next 75 years is estimated to require some combination of spending 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



<sup>25</sup> 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.

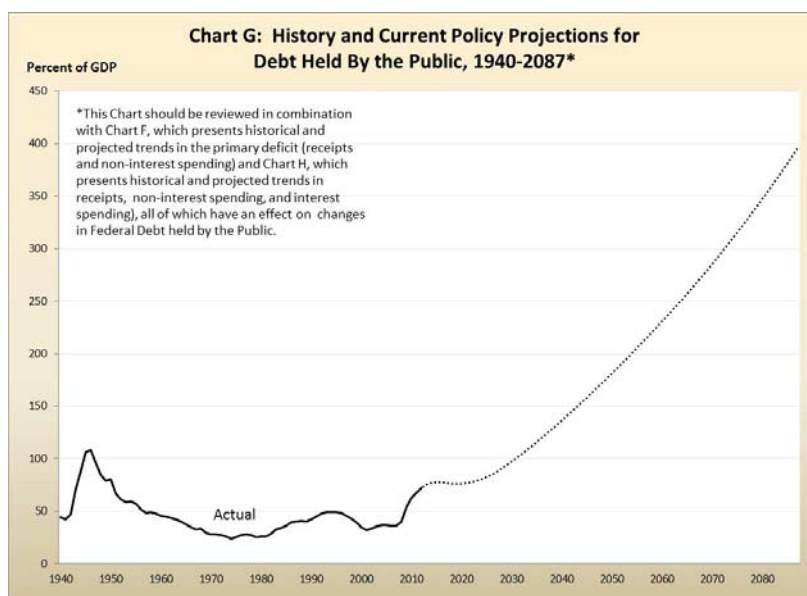
<sup>26</sup> ATRA did not extend the 2001/2003 tax cuts for high income individuals and families that were assumed to occur in the projections. Updating the projections in this *Report* to account for ATRA would therefore modestly reduce projected long term fiscal imbalances.

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)<sup>27</sup> 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.

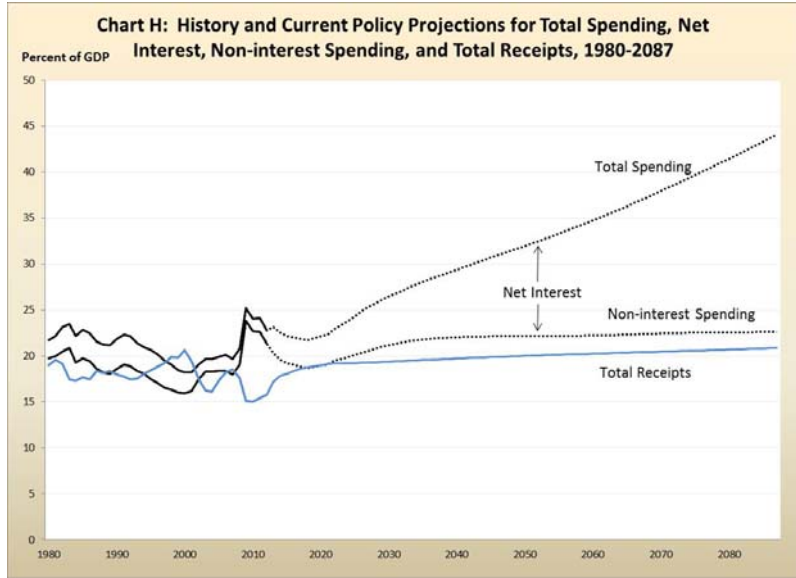


<sup>27</sup> [P.L. 111-148](#), as amended by [P.L. 111-152](#). The ACA expands health insurance coverage, provides health insurance subsidies for low-income individuals and families, includes many measures designed to reduce health care cost growth, and reduces the annual increases in Medicare payment 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 illustrates the cost of delaying policy to close the fiscal gap by comparing three policies that begin on different dates.

<b>Period of Delay</b>	<b>Change in Average Primary Surplus</b>
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.

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*).

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

Dollars in Billions	2012	2011	Increase / (Decrease)	
			\$	%
<b>Open Group (Net):</b>				
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%
<b>Total Social Insurance Expenditures, Net (Open Group)</b>	<b>\$ (38,554)</b>	<b>\$ (33,830)</b>	<b>\$ 4,724</b>	<b>14%</b>
<b>Total Social Insurance Expenditures, Net (Closed Group)</b>	<b>\$ (51,604)</b>	<b>\$ (46,272)</b>	<b>\$ 5,332</b>	<b>12%</b>
<b>Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)*</b>				
<b>Open Group</b>				
Social Security (OASDI)	-1.2%	-1.0%		
Medicare (Parts A, B, & D)	-3.0%	-2.8%		
Other	0.0%	0.0%		
<b>Total (Open Group)</b>	<b>-4.2%</b>	<b>-3.8%</b>		
<b>Total (Closed Group)</b>	<b>-5.6%</b>	<b>-5.3%</b>		

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 current 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.

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.<sup>28</sup>

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.<sup>29</sup> 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

Dollars in Billions	2012	2011
<b>Net Present Value (NPV) - Open Group (Beginning of the Year)</b>	<b>\$ (33,830)</b>	<b>(30,857)</b>
<b>Change In:</b>		
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 <sup>1</sup>	\$ (2,601)	\$ (463)
Change in projection base	\$ 289	\$ (31)
<b>Net Change in Open Group measure</b>	<b>\$ (4,724)</b>	<b>\$ (2,974)</b>
<b>NPV - Open Group (End of the Year)</b>	<b>\$ (38,554)</b>	<b>\$ (33,830)</b>

<sup>1</sup> Reported by HHS.

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

decrease the present value of future cashflows.<sup>30</sup> 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.

As was reported in the FY 2011 and 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.<sup>31</sup> 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

<sup>28</sup> See also Note 28 – Subsequent Events – of this Report.

<sup>29</sup> '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.

<sup>30</sup> [FY 2012 HHS Agency Financial Report](#) p. 119, FY 2012 SSA Performance and Accountability Report, p. 142.

<sup>31</sup> [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.<sup>32</sup>

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.

<sup>32</sup> [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.<sup>33</sup> 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.

<sup>33</sup> 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 innovative 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 Memorandum 12-01, “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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Comptroller General  
of the United States

United States Government Accountability Office  
Washington, DC 20548

January 17, 2013

The President  
The President of the Senate  
The Speaker of the House of Representatives

During fiscal year 2012, the federal government continued to face economic and fiscal challenges in a slow-growth economy with high unemployment. To operate as effectively and efficiently as possible and to make difficult decisions to address the federal government's fiscal challenges, Congress, the administration, and federal managers must have ready access to reliable and complete financial and performance information—both for individual federal entities and for the federal government as a whole. Even though significant progress has been made since the enactment of key federal financial management reforms in the 1990s, our report on the U.S. government's consolidated financial statements illustrates that much work remains to improve federal financial management. Further improvements are urgently needed.

Our report on the U.S. government's consolidated financial statements is enclosed. In summary, we found the following:

- Certain material weaknesses<sup>1</sup> in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that prevented us from expressing an opinion on the fiscal years 2012 and 2011 accrual-based consolidated financial statements.<sup>2</sup> About 34 percent of the federal government's reported total assets as of September 30, 2012, and approximately 21 percent of the federal government's reported net cost for fiscal year 2012 relate to the Department of Defense (DOD), which received a disclaimer of opinion on its consolidated financial statements.

<sup>1</sup>A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

<sup>2</sup>The accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011 consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. Two additional statements that do not interrelate with the accrual-based consolidated financial statements are also included: the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, and related notes.

- Because of significant uncertainties, primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, we are unable to, and we do not, express opinions on the 2012, 2011, and 2010 Statements of Social Insurance, as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts. About \$27.2 trillion, or 70.5 percent, of the reported total present value of future expenditures in excess of future revenue presented in the 2012 Statement of Social Insurance relates to Medicare programs reported in the Department of Health and Human Services' 2012 Statement of Social Insurance, which received a disclaimer of opinion.<sup>3</sup>
- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2012.
- Our tests of compliance with selected provisions of laws and regulations for fiscal year 2012 were limited by the material weaknesses and other scope limitations discussed in our report.

While significant progress has been made in improving federal financial management since the federal government began preparing consolidated financial statements 16 years ago, three major impediments continued to prevent us from rendering an opinion on the federal government's accrual-based consolidated financial statements over this period: (1) serious financial management problems at DOD that have prevented its financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements.

It is important to emphasize that the vast majority of the 24 Chief Financial Officers Act agencies received unqualified opinions on their respective entities' financial statements. However, DOD and the Department of Homeland Security (DHS) have consistently been unable to receive such audit opinions. Efforts are under way at both entities to address this situation. At DOD, following years of unsuccessful financial improvement efforts, the DOD Comptroller established the Financial Improvement and Audit Readiness (FIAR) Directorate to develop, manage, and implement a strategic approach for addressing internal control weaknesses and for achieving auditability, and to integrate those efforts with other improvement activities, such as the department's business systems modernization efforts. DOD's current FIAR strategy and methodology focus on two priorities—budgetary information and asset accountability—with an overall goal of preparing auditable departmentwide financial statements by September 30, 2017.<sup>4</sup> Because budgetary information is widely and regularly used for management, one of DOD's highest interim priorities is the improvement of its budgetary information and processes underlying its Statement of Budgetary Resources (SBR). In October 2011, the Secretary of Defense called for a revised plan that would put DOD component

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<sup>3</sup>We issued an unqualified opinion on the Statements of Social Insurance for 2009 and 2008.

<sup>4</sup>Section 1003 of the National Defense Authorization Act for Fiscal Year 2010, Pub. L. No. 111-84, 123 Stat. 2190, 2439-41 (Oct. 28, 2009), made the development and maintenance of the FIAR Plan a statutory requirement. Under the act, the FIAR Plan must ensure that DOD's financial statements are validated as ready for audit by September 30, 2017. More recently, section 1005 of the National Defense Authorization Act for Fiscal Year 2013, Pub. L. No. 112-239, 126 Stat. 1632 (Jan. 2, 2013), added a new requirement for DOD's FIAR Plan to ensure that one of DOD's financial statements, the Statement of Budgetary Resources, is validated as ready for audit by September 30, 2014.

organizations on a pace to achieve SBR audit readiness by the end of fiscal year 2014, an acceleration of the timeline for most components. In response to the revised plan for the SBR, DOD revised its timelines and actions are under way as reported in FIAR Plan Status Reports. However, according to the November 2012 FIAR Plan Status Report, components are still in the early phases of their actions. Moreover, the results of recent work by us and the DOD Office of Inspector General have raised concerns about the ability of DOD components to implement the FIAR Plan effectively.<sup>5</sup>

With respect to DHS, for the first time, it was able to attain a qualified audit opinion on its departmentwide financial statements. The auditor qualified the audit opinion on DHS's fiscal year 2012 financial statements because of DHS's inability to provide sufficient evidence to support certain components of property, plant, and equipment and heritage and stewardship assets presented in the financial statements. In addition, such limitation in the scope of the audit contributed to the auditor's inability to form an opinion on DHS's internal control over financial reporting. It is important that DHS continue to remediate its internal control deficiencies and build on the progress it has made as it moves forward to achieve its ultimate goal of obtaining clean audit opinions on its fiscal year 2013 financial statements and on its internal control over financial reporting.<sup>6</sup>

Various efforts are also under way to address the other two major impediments. During fiscal year 2012, the Department of the Treasury (Treasury) expanded its ongoing efforts, working with federal entities, to help resolve and eliminate material differences in intragovernmental activity and balances. These efforts included developing and implementing a formalized resolution plan and related corrective actions. In addition, Treasury implemented corrective actions to address certain deficiencies regarding the preparation of the consolidated financial statements, including obtaining and utilizing certain interim financial information from federal entities in preparing initial financial statement drafts. Treasury also began to develop a methodology to reconcile the budget deficit to the consolidated financial statements. Fully addressing the numerous issues in these areas will require a strong and sustained commitment by federal entities and leadership by Treasury and the Office of Management and Budget.

The material weaknesses underlying these three major impediments continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an efficient and effective manner.

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<sup>5</sup>GAO, *DOD Financial Management: Marine Corps Statement of Budgetary Resources Audit Results and Lessons Learned*, GAO-11-830 (Washington, D.C.: Sept. 15, 2011, reissued Oct. 17, 2011), and *DOD Financial Management: Improvement Needed in DOD Components' Implementation of Audit Readiness Effort*, GAO-11-851 (Washington, D.C.: Sept. 13, 2011).

<sup>6</sup>Section 2(b) of the DHS Audit Requirement Target Act of 2012, Pub. L. No. 112-217, 126 Stat. 1591 (Dec. 20, 2012) (DART Act) made obtaining an unqualified audit opinion on DHS's financial statements for fiscal year 2013, and each subsequent fiscal year, a statutory requirement. Under the DART Act, DHS must ensure that its consolidated financial statements for fiscal year 2013, and for each subsequent year, are ready in a timely manner and in preparation for an audit in order to obtain an unqualified opinion on the full set of financial statements.

In addition to the material weaknesses referred to above, we identified four other material weaknesses. These are the federal government's inability to (1) determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments, (2) identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, (3) effectively manage its tax collection activities, and (4) effectively monitor and report loans receivable and loan guarantee liabilities. Additional details concerning these material weaknesses and their effect on the accrual-based consolidated financial statements and on the management of federal government operations are presented in our report. Until the problems outlined in our report are adequately addressed, they will continue to have adverse implications for the federal government and American taxpayers.

The last economic recession and the federal government's actions to stabilize financial markets and promote economic recovery, among other factors, continued to significantly affect the federal government's financial condition. The federal government reported a net operating cost of about \$1.3 trillion and a unified budget deficit of approximately \$1.1 trillion for fiscal year 2012, and as of September 30, 2012, debt held by the public had increased to 73 percent of gross domestic product (GDP). As of September 30, 2012, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in reported federal government assets of over \$152 billion (reported net of about \$109 billion in valuation losses), and certain reported liabilities. The ultimate cost of the federal government's actions to stabilize the financial markets and promote economic recovery will not be known for some time as uncertainties related to the valuation of these assets and liabilities are resolved and further federal government actions are taken in fiscal year 2013 and later. While the federal government has significantly reduced assets and liabilities related to its actions to stabilize the financial markets and promote economic recovery, it faces the challenge of determining the most expeditious manner in which to bring closure to its remaining initiatives in these areas while optimizing its investment returns.

Because the valuation of these and certain other assets and liabilities is based on assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions, actual results may be materially different from the reported amounts. Examples of assets and liabilities reported by the federal government that are subject to substantial uncertainty include the following:

- The federal government's consolidated financial statements as of September 30, 2012, include approximately \$109 billion of investments in two government-sponsored enterprises—the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) (reported net of about \$85 billion in valuation losses). In addition, as of September 30, 2012, the financial statements include about \$9 billion of liabilities for future payments to Fannie Mae and Freddie Mac and disclose a projected maximum remaining potential commitment to these entities of about \$282 billion under agreements between Treasury and the entities. The future structures of these two government-sponsored enterprises and the roles they will serve in the mortgage market must still be determined.

- The federal government reported Troubled Asset Relief Program (TARP) direct loans and equity investments of approximately \$40 billion as of September 30, 2012 (reported net of about \$23 billion in valuation losses), of which approximately \$20 billion related to loans to and equity investments in certain entities in the automotive industry.
- The federal government reported that the Pension Benefit Guaranty Corporation's (PBGC) liabilities exceeded its assets by about \$34 billion as of September 30, 2012. PBGC is subject to further losses if plan terminations that are reasonably possible occur.

There are risks that other factors could affect the federal government's financial condition in the future, including the following:

- The U.S. Postal Service (USPS) is facing a deteriorating financial situation as it reached its borrowing limit of \$15 billion in fiscal year 2012 and finished the year with a reported net loss of almost \$16 billion.
- The Federal Housing Administration (FHA) reported that its liabilities exceeded its assets by about \$15 billion as of September 30, 2012, and that the capital ratio for its Mutual Mortgage Insurance Fund fell below zero during the fiscal year. In addition, the ultimate roles of Fannie Mae and Freddie Mac in the mortgage market may further affect FHA's financial condition.
- Several initiatives undertaken during the last 4 years by the Board of Governors of the Federal Reserve System to stabilize the financial markets have led to a significant change in the composition and size of reported securities on the Federal Reserve's balance sheet. The value of these securities, which include mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and the Government National Mortgage Association, is subject to interest rate risk and may decline or increase depending on interest rate changes. Therefore, if the Federal Reserve sells these securities at a loss, future payments of Federal Reserve earnings to the federal government may be reduced.<sup>7</sup>

GAO's High-Risk list includes some of the issues discussed above such as information security, USPS and DOD financial management, and the PBGC insurance program.<sup>8</sup> Every 2 years, GAO provides Congress with an update on its High-Risk series, which highlights federal entities and program areas that are high risk due to their vulnerabilities to fraud, waste, abuse, and mismanagement or are most in need of broad reform. We plan to update our High-Risk series in early 2013.

Increased attention to risks that could affect the federal government's financial condition is made more important because of the nation's longer-term fiscal challenges. The comprehensive long-term fiscal projections presented in the unaudited Required Supplementary Information section of the *2012 Financial Report of the United States*

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<sup>7</sup>Under Federal Reserve System policy, excess Federal Reserve Bank earnings are paid to the federal government. The federal government reported such net earnings of about \$82 billion for fiscal year 2012, still well above its historical levels.

<sup>8</sup>GAO, *High-Risk Series: An Update*, GAO-11-278 (Washington, D.C.: February 2011).

*Government (2012 Financial Report)* show that—absent policy changes—the federal government continues to face an unsustainable fiscal path. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare benefits. Under these projections, spending for the major health and retirement programs will increase in coming decades as more members of the baby-boom generation become eligible for benefits and the health care cost for each enrollee increases. Over the long term, the structural imbalance between spending and revenue will lead to continued growth of debt held by the public as a share of GDP; this means the current structure of the federal budget is unsustainable.

These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. If, however, the cost containment measures are not sustained over the long term—a concern expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow much more rapidly. GAO also prepares long-term federal fiscal simulations, which continue to show debt rising as a share of GDP.<sup>9</sup> Under GAO's Alternative simulation,<sup>10</sup> which uses the CMS Office of the Actuary's alternative health care cost projections, future spending in excess of receipts would be greater and debt held by the public as a share of GDP would grow more quickly than the projections in the *2012 Financial Report*.

In January 2013, the American Taxpayer Relief Act of 2012<sup>11</sup> was enacted, which affected taxes and made some changes to the Budget Control Act of 2011.<sup>12</sup> Congress will be considering further legislative changes to address the fiscal challenges.

Reliable financial and performance information is even more critical as (1) federal managers likely face increasingly tight budget constraints and need to operate their respective entities as efficiently and effectively as possible and (2) decision makers carry out the important task of deciding how to use multiple tools (tax provisions, discretionary spending, mandatory spending, and credit programs) to address the federal government's fiscal challenges.

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<sup>9</sup>GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2012 Update*, GAO-13-148SP (Washington, D.C.: Dec. 3, 2012).

<sup>10</sup>GAO's Fall 2012 Alternative simulation incorporates the CMS Office of the Actuary's alternative projections for health care cost growth, which assume physician payments are not reduced as specified under current law and certain cost controls are not maintained over the long term. Also in this simulation, expiring tax provisions other than the Social Security payroll tax reductions are extended to 2022 and the alternative minimum tax exemption amount is indexed to inflation through 2022. In the Alternative simulation, discretionary spending follows the original discretionary spending caps set by the Budget Control Act of 2011 but not the lower caps triggered by the automatic enforcement procedures. Over the long term, discretionary spending and revenue are held at their historical average share of GDP.

<sup>11</sup>The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (Jan. 2, 2013).

<sup>12</sup>The Budget Control Act of 2011, Pub. L. No. 112-25, § 302, 125 Stat. 240, 256-59 (Aug. 2, 2011).

On December 26, 2012, the Secretary of the Treasury notified Congress that, on December 31, 2012, the federal government would reach its debt limit.<sup>13</sup> On December 31, 2012, Treasury began deviating from its normal debt management operations and taking a number of actions, referred to by Treasury as extraordinary actions, to avoid exceeding the debt limit. As of the date of our audit report, the debt limit has not been increased. As we have previously reported, the debt limit does not restrict Congress's ability to enact spending and revenue legislation that affects the level of debt or otherwise constrains fiscal policy; it restricts Treasury's authority to borrow to finance the decisions already enacted by Congress and the President.<sup>14</sup> The United States benefits from the confidence investors have that debt backed by the full faith and credit of the United States will be honored. As we have also previously reported, delays in raising the debt limit can create uncertainty in the Treasury market and lead to higher Treasury borrowing costs. We estimated, as reported in July 2012, that delays in raising the debt limit in 2011 led to an increase in Treasury's borrowing costs of about \$1.3 billion in fiscal year 2011. However, this does not account for the multiyear effects on increased costs for Treasury securities that will remain outstanding after fiscal year 2011. In both our February 2011 and July 2012 reports, we noted that Congress should consider ways to better link decisions about the debt limit with decisions about spending and revenue to avoid potential disruptions to the Treasury market and to help inform the fiscal policy debate in a timely way.

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Our report on the U.S. government's consolidated financial statements would not be possible without the commitment and professionalism of inspectors general throughout the federal government who are responsible for annually auditing the financial statements of individual federal entities. We also appreciate the cooperation and assistance of Department of the Treasury and Office of Management and Budget officials as well as the federal entities' chief financial officers. We look forward to continuing to work with these individuals, the administration, and Congress to achieve the goals and objectives of federal financial management reform.

Our report begins on page 223. Our guide<sup>15</sup> to the *Financial Report of the United States Government* is intended to help those who seek to obtain a better understanding of the *Financial Report* and is available on GAO's website at [www.gao.gov](http://www.gao.gov). In addition, the website includes a guide<sup>16</sup> to understanding the differences between accrual and cash

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<sup>13</sup>Congress and the President have enacted laws to establish a limit on the amount of federal debt that can be outstanding at one time, referred to as the debt limit. The debt limit is codified at 31 U.S.C. §§ 3101 and 3101A.

<sup>14</sup>GAO, *Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs*, GAO-12-701 (Washington, D.C.: July 23, 2012), and *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, GAO-11-203 (Washington, D.C.: Feb. 22, 2011).

<sup>15</sup>GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-946SP (Washington, D.C.: September 2009).

<sup>16</sup>See <http://www.gao.gov/special.pubs/longterm/deficit/>, which is based on information in GAO, *Understanding Similarities and Differences between Accrual and Cash Deficits*, GAO-07-117SP (Washington, D.C.: December 2006). In January 2007 and 2008, we issued updates to this guide for fiscal years 2006 and 2007; see GAO-07-341SP (Washington, D.C.: January 2007) and GAO-08-410SP (Washington, D.C.: January 2008).

measures of the deficit and provides a useful perspective on the different purposes cash and accrual measures serve in providing a comprehensive picture of the federal government's fiscal condition today and over time.

Our report was prepared under the direction of Robert F. Dacey, Chief Accountant, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-3406.



Gene L. Dodaro  
Comptroller General  
of the United States

cc: The Majority Leader of the Senate  
The Minority Leader of the Senate  
The Majority Leader of the House of Representatives  
The Minority Leader of the House of Representatives



# Financial Statements of the United States Government for the Years Ended September 30, 2012, and 2011

## Statements of Net Cost

These statements present the net cost of fiscal years 2012 and 2011 United States Government (Government)<sup>1</sup> operations, including the operations related to earmarked funds (funds financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time). The Government's fiscal year begins October 1 and ends September 30. Costs and earned revenues are categorized on the Statement of Net Cost by significant entity, providing greater accountability by showing the relationship of the agencies' net cost to the Governmentwide net cost. Costs and earned revenues are presented in this report by department on an accrual basis, while the budget presents costs and revenues by obligations and receipts, generally on a cash basis. The focus of the budget of the United States is by agency. Budgets are prepared, defended, and monitored by agency. In reporting by agency, we are assisting the external users in assessing the budget integrity, operating performance, stewardship, and systems and controls of the Government.

These statements contain the following four components:

- Gross cost—is the full cost of all the departments and entities excluding (gain)/loss from changes in assumptions. These costs are assigned on a cause-and-effect basis, or reasonably allocated to the corresponding departments and entities.
- Earned revenue—is exchange revenue resulting from the Government providing goods and services to the public at a price.
- (Gain)/loss from changes in assumptions—is the loss or gain from changes in long-term assumptions used to measure the liabilities reported for Federal civilian and military employee pensions, other post-employment benefits, and other retirement benefits, including veterans' compensation.
- Net cost—is computed by subtracting earned revenue from gross cost, adjusted by the (gain)/loss from changes in assumptions.

Individual agency net cost amounts will differ with the agency's financial statements because of allocations of certain Office of Personnel Management (OPM) costs and intragovernmental eliminations. Because of their specific function, most of the costs originally associated with OPM have been allocated to their user agencies for Governmentwide reporting purposes. The remaining costs for OPM on the Statements of Net Cost are the administrative operating costs, the expenses from prior and past costs from health and pension plan amendments, and the actuarial gains and losses, if applicable. The interest on securities issued by the Department of the Treasury (Treasury) and held by the public is reported on Treasury's financial statements, but, because of its importance and the dollar amounts involved, it is reported separately in these statements.

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<sup>1</sup> For purposes of this document, "Government" refers to the U.S. Government.

## Statements of Operations and Changes in Net Position

These statements report the results of Government operations, which include the results of operations for earmarked funds. They include non-exchange revenues that are generated principally by the Government's sovereign power to tax, levy duties, and assess fines and penalties. These statements also present the cost of Government operations, net of revenue earned from the sale of goods and services to the public (exchange revenue). They further include certain adjustments and unreconciled transactions that affect the net position.

### Revenue

Individual income tax and tax withholdings include Federal Insurance Contributions Act (FICA)/Self-Employment Contributions Act (SECA) taxes and other taxes. These taxes are characterized as non-exchange revenue.

Excise taxes consist of taxes collected for various items, such as airline tickets, gasoline products, distilled spirits and imported liquor, tobacco, firearms, and others. These also are characterized as non-exchange revenue.

Other taxes and receipts include Federal Reserve banks (FRBs) earnings, tax related fines, penalties and interest, and railroad retirement taxes.

Miscellaneous earned revenues consist of earned revenues received from the public with virtually no associated cost. These revenues include rents and royalties on the Outer Continental Shelf Lands resulting from the leasing and development of mineral resources on public lands.

Earmarked revenues are required by statute to be used for designated activities, benefits or purposes and must be accounted for separately from the rest of the Government's non-earmarked revenues. See Note 24—Earmarked Funds for detailed information.

Intragovernmental interest represents interest earned from the investment of surplus earmarked revenues, which finance the deficit spending of non-earmarked operations. These investments are recorded as intragovernmental debt holdings and are included in Note 14—Federal Debt Securities Held by the Public and Accrued Interest, in the table titled Intragovernmental Debt Holdings: Federal Debt Securities Held as Investments by Government Accounts. These interest payments and the associated investments are eliminated in the consolidation process.

### Net Cost of Government Operations

The net cost of Government operations (gross cost [including (gains)/losses from changes in assumptions] less earned revenue) flows through from the Statements of Net Cost. The net cost associated with earmarked activities is separately reported.

### Intragovernmental Transfers

Intragovernmental transfers reflect amounts required by statute to be transferred from the General Fund of the Treasury to earmarked funds. An example is the annual transfer to the Department of Health and Human Services' (HHS) Supplementary Medical Insurance Trust Fund (Medicare Parts B and D) which receives approximately 75 percent and 74 percent, respectively, of its funding from the General Fund.

## Unmatched Transactions and Balances

Unmatched transactions and balances are adjustments needed to bring the change in net position into balance due to unreconciled intragovernmental differences, agency reporting errors, timing differences, and General Fund transactions in the consolidated financial statements. See Note 1.T—Unmatched Transactions and Balances for detailed information.

## Net Position, Beginning of Period

The net position, beginning of period, reflects the net position reported on the prior year's balance sheet as of the end of that fiscal year. The net position for earmarked funds is shown separately.

Prior-period adjustments are revisions to adjust the beginning net position and balances presented on the prior year financial statements due to corrections of errors or changes in accounting principles. See Note 21—Prior Period Adjustments for detailed information.

## Net Position, End of Period

The net position, end of period, amount reflects the net position as of the end of the fiscal year. The net position for earmarked funds is separately shown.

## Reconciliations of Net Operating Cost and Unified Budget Deficit

These statements reconcile the results of operations (net operating cost) on the Statements of Operations and Changes in Net Position to the unified budget deficit. The premise of the reconciliation is that the accrual and budgetary accounting bases share transaction data.

Receipts and outlays in the budget are measured primarily on a cash basis and differ from the accrual basis of accounting used in the *Financial Report*. Refer to Note 1.B—Basis of Accounting and Revenue Recognition for details. These statements begin with the net results of operations (net operating cost), where operating revenues are reported on a modified cash basis of accounting and the net cost of Government operations on an accrual basis of accounting and reports activities where the bases of accounting for the components of net operating cost and the unified budget deficit differ.

## Components of Net Operating Cost Not Part of the Budget Deficit

This information includes the operating components, such as the changes in benefits payable for veterans, military and civilian employees, the environmental liabilities, and depreciation expense, not included in the budget results.

## Components of the Budget Deficit Not Part of Net Operating Cost

This information includes the budget components, such as capitalized fixed assets that are recorded as outlays in the budget when purchased and reflected in net operating cost through depreciation expense over the useful life of the asset, and increases in other assets, that are not included in the operating results.

## Statements of Changes in Cash Balance from Unified Budget and Other Activities

The primary purpose of these statements is to report how the annual unified budget deficit relates to the change in the Government's cash and other monetary assets and debt held by the public. It explains why the unified budget deficit normally would not result in an equivalent change in the Government's cash and other monetary assets.

These statements reconcile the unified budget deficit to the change in cash and other monetary assets during the fiscal year and explain how the budget deficits were financed. A budget deficit is the result of outlays (expenditures) exceeding receipts (revenue) during a particular fiscal year.

The budget deficit is financed through borrowings from the public. Other transactions such as the payment of interest on debt held by the public also require cash disbursements and are not part of the deficit. The budget deficit also includes certain amounts that are recognized in the budget and will be disbursed in a future period or are adjustments that did not affect the cash balance. These amounts include interest accrued on debt issued by Treasury and held by the public and subsidy expense related to direct and guaranteed loans as well as equity investment activity and did not contribute to the change in the cash balance.

These statements show the adjustments for noncash outlays included in the budget and items affecting the cash balance not included in the budget to explain the change in cash and other monetary assets.

## Balance Sheets

The balance sheets show the Government's assets, liabilities, and net position. When combined with stewardship information, this information presents a more comprehensive understanding of the Government's financial position. The net position for earmarked funds is shown separately.

### Assets

Assets included on the balance sheets are resources of the Government that remain available to meet future needs. The most significant assets that are reported on the balance sheets are loans receivable and mortgage-backed securities, net; property, plant, and equipment (PP&E), net; inventories and related property, net; and cash and other monetary assets. There are, however, other significant resources available to the Government that extend beyond the assets presented in these balance sheets. Those resources include the Government's sovereign powers to tax, and set monetary policy.

### Liabilities and Net Position

Liabilities are obligations of the Government resulting from prior actions that will require financial resources. The most significant liabilities reported on the balance sheets are Federal debt securities held by the public and accrued interest and Federal employee and veteran benefits payable. Liabilities also include environmental and disposal liabilities, liabilities to Government-Sponsored Enterprises (GSEs), benefits due and payable, and insurance and guarantee program liabilities.

As with reported assets, the Government's responsibilities, policy commitments, and contingencies are much broader than these reported balance sheet liabilities. They include the social insurance programs reported in the Statements of Social Insurance and disclosed in the Required Supplementary Information—Social Insurance section, the fiscal long-term projections of non-interest spending disclosed in the Required Supplementary Information—Statement of Fiscal Projections for the United States Government (U.S. Government) section, and a wide range of other programs under which the Government provides benefits and services to the people of this Nation, as well as certain future loss contingencies.

The Government has entered into contractual commitments requiring the future use of financial resources and has unresolved contingencies where existing conditions, situations, or circumstances create uncertainty about future losses. Commitments, as well as contingencies that do not meet the criteria for recognition as liabilities on the balance sheets, but for which there is at least a reasonable possibility that losses have been incurred, are disclosed in Note 22—Contingencies and Note 23—Commitments.

The collection of earmarked taxes and other earmarked revenue is credited to the corresponding Earmarked Fund that will use these funds to meet a particular Government purpose. If the collections from taxes and other sources exceed the payments to the beneficiaries, the excess revenue is invested in Treasury securities or "loaned" to Treasury's General Fund; therefore, the trust fund balances do not represent cash. An explanation of the trust funds for social insurance and many of the other large trust funds is included in Note 24—Earmarked Funds. That note also contains information about trust fund receipts, disbursements, and assets.

Because of its sovereign power to tax and borrow, and the country's wide economic base, the Government has unique access to financial resources through generating tax revenues and issuing Federal debt securities. This provides the Government with the ability to meet present obligations and those that are anticipated from future operations and are not reflected in net position.

The net position is the residual difference between assets and liabilities and is the cumulative results of operations since inception. For detailed components that comprise the net position, refer to the section "Statement of Operations and Changes in Net Position."

## Statements of Social Insurance and Changes in Social Insurance Amounts

The Statements of Social Insurance provide estimates of the status of the most significant social insurance programs: Social Security, Medicare, Railroad Retirement, and Black Lung social insurance programs. They are administered by the Social Security Administration (SSA), HHS, the Railroad Retirement Board (RRB), and the Department of Labor (DOL), respectively. The estimates are actuarial present values<sup>2</sup> of the projections and are based on the economic and demographic assumptions representing the trustees' reasonable estimates as set forth in the relevant Social Security and Medicare trustees' reports and in the agency financial report of HHS and DOL (Black Lung) and in the relevant agency performance and accountability reports for the SSA and RRB. The projections are based on the continuation of program provisions contained in current law.

The magnitude and complexity of social insurance programs, coupled with the extreme sensitivity of projections relating to the many assumptions of the programs, produce a wide range of possible results. In preparing the Statements of Social Insurance, Government management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statements. However, because of the large number of factors that affect the Statements of Social Insurance and the fact that such assumptions are inherently subject to substantial uncertainty (arising from the likelihood of future events, significant uncertainties, and contingencies), there will be differences between the estimates in the Statements of Social Insurance and the actual results, and those differences may be material. Note 26—Social Insurance describes the social insurance programs, reports long-range estimates that can be used to assess the financial condition of the programs, and explains some of the factors that impact the various programs. The Statements of Changes in Social Insurance Amounts reconcile the change between the current valuation period and the prior valuation period.

<sup>2</sup> Present values recognize that a dollar paid or collected in the future is worth less than a dollar today, because a dollar today could be invested and earn interest. To calculate a present value, future amounts are thus reduced using an assumed interest rate, and those reduced amounts are summed.

**United States Government  
Statement of Net Cost  
for the Year Ended September 30, 2012**

(In billions of dollars)	Gross Cost	Earned Revenue	Subtotal	(Gain)/Loss from Changes in Assumptions	Net Cost
Department of Health and Human Services.....	924.0	67.8	856.2	0.3	856.5
Social Security Administration .....	825.4	0.3	825.1	-	825.1
Department of Defense .....	784.7	56.0	728.7	70.4	799.1
Department of Veterans Affairs .....	213.6	4.1	209.5	149.3	358.8
Interest on Treasury Securities Held by the Public .....	245.4	-	245.4	-	245.4
Department of Agriculture.....	161.0	12.0	149.0	-	149.0
Office of Personnel Management.....	48.2	19.1	29.1	98.9	128.0
Department of Labor.....	107.3	-	107.3	-	107.3
Department of Transportation.....	79.0	0.8	78.2	-	78.2
Department of Housing and Urban Development.....	74.5	1.5	73.0	-	73.0
Department of Energy .....	60.8	4.3	56.5	-	56.5
Department of Homeland Security .....	58.2	9.9	48.3	0.4	48.7
Department of Education.....	62.7	20.0	42.7	-	42.7
Department of Justice.....	38.9	1.3	37.6	-	37.6
Department of State.....	29.8	3.5	26.3	0.8	27.1
Department of the Interior.....	23.3	2.7	20.6	-	20.6
National Aeronautics and Space Administration .....	19.0	0.2	18.8	-	18.8
Agency for International Development .....	11.4	0.2	11.2	-	11.2
Environmental Protection Agency .....	11.4	0.3	11.1	-	11.1
Railroad Retirement Board .....	15.3	5.1	10.2	-	10.2
Department of Commerce .....	12.8	2.6	10.2	-	10.2
Pension Benefit Guaranty Corporation.....	20.2	10.4	9.8	-	9.8
Federal Communications Commission.....	10.1	0.4	9.7	-	9.7
U.S. Postal Service.....	72.8	64.2	8.6	-	8.6
National Science Foundation.....	7.4	-	7.4	-	7.4
Small Business Administration .....	1.6	0.4	1.2	-	1.2
Smithsonian Institution .....	0.8	-	0.8	-	0.8
Export-Import Bank of the United States.....	1.2	0.8	0.4	-	0.4
U.S. Nuclear Regulatory Commission.....	1.1	0.8	0.3	-	0.3
National Credit Union Administration.....	1.3	1.0	0.3	-	0.3
General Services Administration .....	0.5	0.5	-	-	-
Farm Credit System Insurance Corporation .....	-	0.1	(0.1)	-	(0.1)
Tennessee Valley Authority .....	11.0	11.3	(0.3)	0.1	(0.2)
Securities and Exchange Commission .....	1.2	1.6	(0.4)	-	(0.4)
Federal Deposit Insurance Corporation .....	2.6	19.3	(16.7)	-	(16.7)
Department of the Treasury.....	(150.0)	27.5	(177.5)	-	(177.5)
All other entities .....	56.4	0.8	55.6	-	55.6
<b>Total .....</b>	<b>3,844.9</b>	<b>350.8</b>	<b>3,494.1</b>	<b>320.2</b>	<b>3,814.3</b>

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statement of Net Cost  
for the Year Ended September 30, 2011**

(In billions of dollars)	Gross Cost	Earned Revenue	Subtotal	(Gain)/Loss from Changes in Assumptions	Net Cost
Department of Health and Human Services.....	943.3	66.4	876.9	0.1	877.0
Social Security Administration .....	782.9	0.4	782.5	-	782.5
Department of Defense .....	827.0	78.0	749.0	(32.0)	717.0
Department of Veterans Affairs .....	123.7	4.7	119.0	58.9	177.9
Interest on Treasury Securities Held by the Public .....	250.9	-	250.9	-	250.9
Department of Agriculture.....	153.8	9.4	144.4	-	144.4
Office of Personnel Management.....	43.6	19.1	24.5	0.3	24.8
Department of Labor.....	132.7	-	132.7	-	132.7
Department of Transportation.....	77.7	0.7	77.0	-	77.0
Department of Housing and Urban Development.....	60.7	1.2	59.5	-	59.5
Department of Energy .....	52.5	7.9	44.6	-	44.6
Department of Homeland Security .....	58.6	9.4	49.2	0.4	49.6
Department of Education.....	69.7	15.0	54.7	-	54.7
Department of Justice.....	31.1	1.3	29.8	-	29.8
Department of State.....	26.9	3.4	23.5	0.4	23.9
Department of the Interior.....	23.6	2.7	20.9	-	20.9
National Aeronautics and Space Administration .....	18.7	0.1	18.6	-	18.6
Agency for International Development .....	12.1	0.7	11.4	-	11.4
Environmental Protection Agency .....	11.2	0.5	10.7	-	10.7
Railroad Retirement Board .....	16.9	5.9	11.0	-	11.0
Department of Commerce .....	11.2	2.5	8.7	-	8.7
Pension Benefit Guaranty Corporation.....	12.8	7.4	5.4	-	5.4
Federal Communications Commission.....	9.3	0.4	8.9	-	8.9
U.S. Postal Service.....	61.7	64.6	(2.9)	-	(2.9)
National Science Foundation.....	7.1	-	7.1	-	7.1
Small Business Administration .....	3.6	0.4	3.2	-	3.2
Smithsonian Institution .....	0.7	-	0.7	-	0.7
Export-Import Bank of the United States.....	0.6	0.7	(0.1)	-	(0.1)
U.S. Nuclear Regulatory Commission .....	1.0	0.8	0.2	-	0.2
National Credit Union Administration.....	0.2	3.1	(2.9)	-	(2.9)
General Services Administration .....	0.3	0.6	(0.3)	-	(0.3)
Farm Credit System Insurance Corporation .....	-	0.1	(0.1)	-	(0.1)
Tennessee Valley Authority.....	11.5	11.8	(0.3)	-	(0.3)
Securities and Exchange Commission .....	1.0	1.6	(0.6)	-	(0.6)
Federal Deposit Insurance Corporation .....	(2.2)	13.7	(15.9)	-	(15.9)
Department of the Treasury.....	114.8	30.6	84.2	-	84.2
All other entities .....	47.1	0.5	46.6	-	46.6
<b>Total .....</b>	<b>3,998.3</b>	<b>365.6</b>	<b>3,632.7</b>	<b>28.1</b>	<b>3,660.8</b>

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statements of Operations and Changes in Net Position  
for the Years Ended September 30, 2012, and 2011**

(In billions of dollars)	Non- Earmarked Funds	Earmarked Funds	Consolidated	Non- Earmarked Funds	Earmarked Funds	Consolidated
	2012			2011		
<b>Revenue:</b>						
Individual income tax and tax withholdings ...	1,135.2	789.9	1,925.1	1,092.9	772.9	1,865.8
Corporation income taxes .....	237.5		237.5	175.1		175.1
Unemployment taxes .....		66.5	66.5		56.1	56.1
Excise taxes .....	24.6	56.5	81.1	21.3	52.2	73.5
Estate and gift taxes .....	13.9		13.9	7.3		7.3
Customs duties .....	28.6		28.6	28.5		28.5
Other taxes and receipts .....	114.9	30.9	145.8	120.4	20.9	141.3
Miscellaneous earned revenues .....	13.5	6.2	19.7	11.3	4.9	16.2
Intragovernmental interest .....		185.3	185.3		202.0	202.0
Total revenue .....	<u>1,568.2</u>	<u>1,135.3</u>	<u>2,703.5</u>	<u>1,456.8</u>	<u>1,109.0</u>	<u>2,565.8</u>
Eliminations.....			(185.3)			(202.0)
Consolidated revenue .....			<u>2,518.2</u>			<u>2,363.8</u>
<b>Net Cost of Government Operations:</b>						
Net cost.....	2,020.2	1,794.1	3,814.3	2,110.6	1,550.2	3,660.8
Intragovernmental interest .....	185.3		185.3	202.0		202.0
Total net cost .....	<u>2,205.5</u>	<u>1,794.1</u>	<u>3,999.6</u>	<u>2,312.6</u>	<u>1,550.2</u>	<u>3,862.8</u>
Eliminations.....			(185.3)			(202.0)
Consolidated net cost.....			<u>3,814.3</u>			<u>3,660.8</u>
<b>Intragovernmental transfers</b> .....	(576.5)	576.5		(540.5)	540.5	
Unmatched transactions and balances (Note 1.T).....	(20.2)		(20.2)	(15.6)		(15.6)
<b>Net operating (cost)/revenue</b> .....	<u>(1,234.0)</u>	<u>(82.3)</u>	<u>(1,316.3)</u>	<u>(1,411.9)</u>	<u>99.3</u>	<u>(1,312.6)</u>
<b>Net position, beginning of period</b> .....	(15,533.6)	748.2	(14,785.4)	(14,119.7)	646.9	(13,472.8)
Prior period adjustments—changes in accounting principles (Note 21).....	1.3	(0.6)	0.7	(2.0)	2.0	-
Net operating (cost)/revenue.....	(1,234.0)	(82.3)	(1,316.3)	(1,411.9)	99.3	(1,312.6)
<b>Net position, end of period</b> .....	<u>(16,766.3)</u>	<u>665.3</u>	<u>(16,101.0)</u>	<u>(15,533.6)</u>	<u>748.2</u>	<u>(14,785.4)</u>

The accompanying notes are an integral part of these financial statements.



**United States Government**  
**Reconciliations of Net Operating Cost and Unified Budget Deficit**  
**for the Years Ended September 30, 2012, and 2011**

(In billions of dollars)	<b>2012</b>	<b>2011</b>
<b>Net operating cost</b> .....	<u>(1,316.3)</u>	<u>(1,312.6)</u>
<b>Components of net operating cost not part of the budget deficit:</b>		
<b>Increase in liability for military employee benefits (Note 15):</b>		
Increase in military pension liabilities.....	120.7	98.6
(Decrease) in military health liabilities.....	(9.0)	(62.4)
(Decrease) in other military benefits.....	<u>(0.6)</u>	<u>(1.2)</u>
Increase in liability for military employee benefits.....	<u>111.1</u>	<u>35.0</u>
<b>Increase in liability for veteran's compensation (Note 15)</b>	<u>227.9</u>	<u>58.9</u>
<b>Increase/(Decrease) in liabilities for civilian employee benefits (Note 15):</b>		
Increase/(decrease) in civilian pension liabilities.....	152.6	(13.2)
(Decrease) in civilian health liabilities.....	(14.4)	(13.0)
Increase in other civilian benefits.....	4.6	4.2
Increase/(decrease) in liabilities for civilian employee benefits.....	<u>142.8</u>	<u>(22.0)</u>
<b>Increase in environmental and disposal liabilities (Note 16):</b>		
Increase in Energy's environmental and disposal liabilities.....	17.8	0.4
(Decrease)/increase in all others' environmental and disposal liabilities.....	<u>(2.9)</u>	<u>2.4</u>
Increase in environmental and disposal liabilities.....	<u>14.9</u>	<u>2.8</u>
Depreciation expense.....	59.1	68.4
Property, plant, and equipment disposals and revaluations.....	9.4	(4.6)
(Decrease)/increase in benefits due and payable.....	(4.8)	6.7
(Decrease) in insurance and guarantee program liabilities.....	(5.3)	(13.9)
Increase in other liabilities.....	5.6	10.5
Increase/(decrease) in accounts payable.....	1.8	(9.5)
(Increase) in net accounts and taxes receivable.....	(4.9)	(11.7)
TARP yearend (downward)/upward re-estimate.....	(9.0)	23.3
(Decrease) in liabilities to Government-sponsored enterprises.....	(307.2)	(43.7)
Increase/(decrease) in valuation loss on investments in Government-sponsored enterprises.....	42.3	(3.0)
<b>Components of the budget surplus (or deficit) that are not part of net operating revenue/(or cost):</b>		
<b>Capitalized fixed assets:</b>		
Department of Defense.....	(33.6)	(51.3)
All other agencies.....	<u>(37.1)</u>	<u>(36.4)</u>
Total capitalized fixed assets.....	<u>(70.7)</u>	<u>(87.7)</u>
Effect of prior year TARP (upward)/downward re-estimate.....	(23.3)	23.6
(Increase) in inventory.....	(2.9)	(9.9)
(Increase) in investments in Government-sponsored enterprises.....	(18.6)	(20.8)
Decrease in debt and equity securities.....	0.4	9.1
Decrease in other assets.....	21.7	4.0
Credit reform and other loan activities.....	38.6	(4.3)
All other reconciling items.....	<u>(2.0)</u>	<u>2.8</u>
<b>Unified budget deficit</b> .....	<u><u>(1,089.4)</u></u>	<u><u>(1,298.6)</u></u>

The accompanying notes are an integral part of these financial statements.

**United States Government**  
**Statements of Changes in Cash Balance from Unified Budget and Other Activities**  
**for the Years Ended September 30, 2012, and 2011**

(In billions of dollars)	2012	2011
<b>Unified budget deficit</b> .....	(1,089.4)	(1,298.6)
<b>Adjustments for noncash outlays included in the budget:</b>		
Interest accrued by Treasury on debt held by the public .....	240.1	244.2
TARP yearend re-estimates .....	32.3	(46.9)
TARP Subsidy (income)/expense (Note 5).....	(10.8)	7.2
Other Federal entity subsidy (income) (Note 4).....	(29.4)	(43.9)
Subtotal .....	232.2	160.6
<b>Items affecting the cash balance not included in the budget:</b>		
<i>Net Transactions from financing activity:</i>		
Borrowings from the public .....	7,766.9	7,962.8
Repayment of debt held by the public .....	(6,614.0)	(6,854.2)
Agency securities .....	(0.4)	1.0
Subtotal .....	1,152.5	1,109.6
<i>Transactions from monetary and other activity:</i>		
Interest paid by Treasury on debt held by the public.....	(234.3)	(239.7)
Net TARP direct loans and equity investments activity .....	52.3	59.0
Net Government-sponsored enterprises —mortgage-backed securities activity .....	70.6	93.7
Net loan receivable activity .....	(153.7)	(157.6)
Allocations of special drawing rights .....	(0.7)	0.2
Other .....	(0.3)	21.2
Subtotal .....	(266.1)	(223.2)
<b>Cash and other monetary assets (Note 2):</b>		
Increase/(decrease) in cash and other monetary assets .....	29.2	(251.6)
Balance, beginning of period .....	177.0	428.6
Balance, end of period .....	206.2	177.0

The accompanying notes are an integral part of these financial statements.

For budgetary purposes, the effect of the yearend downward re-estimates (reduction of net outlays) and upward re-estimates (increase of net outlays) is not recognized until the subsequent fiscal year.

**United States Government  
Balance Sheets  
as of September 30**

(In billions of dollars)	2012	2011
<b>Assets:</b>		
Cash and other monetary assets (Note 2) .....	206.2	177.0
Accounts and taxes receivable, net (Note 3).....	111.2	106.3
Loans receivable and mortgage-backed securities, net (Note 4)...	859.6	772.1
TARP direct loans and equity investments, net (Note 5) .....	40.2	80.1
Inventories and related property, net (Note 7).....	299.0	296.1
Property, plant, and equipment, net (Note 8) .....	855.0	852.8
Debt and equity securities (Notes 6 and 9) .....	110.2	110.6
Investments in Government-sponsored enterprises (Note 11) .....	109.3	133.0
Other assets (Notes 10 and 12) .....	157.6	179.3
Total assets.....	<u>2,748.3</u>	<u>2,707.3</u>
Stewardship land and heritage assets (Note 27)		
<b>Liabilities:</b>		
Accounts payable (Note 13) .....	65.2	63.4
Federal debt securities held by the public and accrued interest (Note 14) .....	11,332.3	10,174.1
Federal employee and veteran benefits payable (Note 15) .....	6,274.0	5,792.2
Environmental and disposal liabilities (Note 16).....	339.0	324.1
Benefits due and payable (Note 17).....	166.2	171.0
Insurance and guarantee program liabilities (Note 18) .....	156.4	161.7
Loan guarantee liabilities (Note 4).....	74.6	63.0
Liabilities to Government-sponsored enterprises (Note 11).....	9.0	316.2
Other liabilities (Notes 10 and 19) .....	432.6	427.0
Total liabilities .....	<u>18,849.3</u>	<u>17,492.7</u>
Contingencies (Note 22) and Commitments (Note 23)		
<b>Net position:</b>		
Earmarked funds (Note 24) .....	665.3	748.2
Non-earmarked funds.....	<u>(16,766.3)</u>	<u>(15,533.6)</u>
Total net position .....	<u>(16,101.0)</u>	<u>(14,785.4)</u>
Total liabilities and net position .....	<u>2,748.3</u>	<u>2,707.3</u>

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statements of Social Insurance (Note 26)  
Present Value of Long-Range (75 Years, except Black Lung) Actuarial Projections**

(In billions of dollars)	2012	2011	2010	2009	2008
<b>Federal Old-Age, Survivors and Disability Insurance (Social Security):</b> <sup>14</sup>					
<i>Revenue (Contributions and Earmarked Taxes) from:</i>					
Participants who have attained eligibility age (62 and over) .....	847	726	672	575	542
Participants who have not attained eligibility age .....	22,703	20,734	19,914	18,559	18,249
Future participants .....	21,649	20,144	19,532	18,082	17,566
All current and future participants .....	45,198	41,603	40,118	37,217	36,357
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained eligibility age (62 and over) .....	(9,834)	(8,618)	(8,096)	(7,465)	(6,958)
Participants who have not attained eligibility age .....	(37,753)	(34,042)	(32,225)	(30,207)	(29,021)
Future participants .....	(8,890)	(8,100)	(7,744)	(7,223)	(6,933)
All current and future participants .....	(56,477)	(50,760)	(48,065)	(44,894)	(42,911)
<i>Present value of future expenditures in excess of future revenue .....</i>	(11,278) <sup>1</sup>	(9,157) <sup>2</sup>	(7,947) <sup>3</sup>	(7,677) <sup>4</sup>	(6,555) <sup>5</sup>
<b>Federal Hospital Insurance (Medicare Part A):</b> <sup>14</sup>					
<i>Revenue (Contributions and Earmarked Taxes) from:</i>					
Participants who have attained eligibility age (65 and over) .....	302	262	248	209	202
Participants who have not attained eligibility age .....	7,929	7,581	7,216	6,348	6,320
Future participants .....	7,367	7,260	6,944	5,451	5,361
All current and future participants .....	15,598	15,104	14,408	12,008	11,883
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained eligibility age (65 and over) .....	(3,369)	(2,923)	(2,648)	(2,958)	(2,747)
Participants who have not attained eligibility age .....	(14,919)	(12,887)	(12,032)	(18,147)	(17,365)
Future participants .....	(2,891)	(2,546)	(2,411)	(4,673)	(4,506)
All current and future participants .....	(21,179)	(18,356)	(17,091)	(25,778)	(24,619)
<i>Present value of future expenditures in excess of future revenue .....</i>	(5,581) <sup>1</sup>	(3,252) <sup>2</sup>	(2,683) <sup>3</sup>	(13,770) <sup>4</sup>	(12,736) <sup>5</sup>
<b>Federal Supplementary Medical Insurance (Medicare Part B):</b> <sup>14</sup>					
<i>Revenue (Premiums) from:</i>					
Participants who have attained eligibility age (65 and over) .....	635	570	538	498	461
Participants who have not attained eligibility age .....	3,826	3,651	3,460	4,224	3,859
Future participants .....	884	865	839	1,270	1,158
All current and future participants .....	5,344	5,086	4,836	5,992	5,478
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained eligibility age (65 and over) .....	(2,646)	(2,343)	(2,166)	(2,142)	(1,986)
Participants who have not attained eligibility age .....	(14,303)	(13,489)	(12,587)	(16,342)	(14,949)
Future participants .....	(3,211)	(3,108)	(2,984)	(4,672)	(4,262)
All current and future participants .....	(20,159)	(18,940)	(17,737)	(23,156)	(21,197)
<i>Present value of future expenditures in excess of future revenue</i> <sup>6</sup> .....	(14,815) <sup>1</sup>	(13,854) <sup>2</sup>	(12,901) <sup>3</sup>	(17,165) <sup>4</sup>	(15,719) <sup>5</sup>

Totals may not equal the sum of components due to rounding.

The accompanying notes are an integral part of these financial statements.

**United States Government**  
**Statements of Social Insurance (Note 26), continued**  
**Present Value of Long-Range (75 Years, except Black Lung) Actuarial Projections**

(In billions of dollars)	2012	2011	2010	2009	2008
<b>Federal Supplementary Medical Insurance (Medicare Part D):</b> <sup>14</sup>					
<i>Revenue (Premiums and State Transfers) from:</i>					
Participants who have attained eligibility age (65 and over) .....	179	173	165	140	123
Participants who have not attained eligibility age .....	1,510	1,608	1,626	1,442	1,380
Future participants .....	661	703	694	618	604
All current and future participants .....	<u>2,349</u>	<u>2,484</u>	<u>2,486</u>	<u>2,199</u>	<u>2,107</u>
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained eligibility age (65 and over) .....	(694)	(695)	(646)	(595)	(581)
Participants who have not attained eligibility age .....	(5,866)	(6,438)	(6,355)	(6,144)	(6,527)
Future participants .....	(2,568)	(2,817)	(2,714)	(2,632)	(2,856)
All current and future participants .....	<u>(9,128)</u>	<u>(9,950)</u>	<u>(9,715)</u>	<u>(9,371)</u>	<u>(9,964)</u>
<i>Present value of future expenditures in excess of future revenue</i> <sup>6</sup> .....	<u>(6,778)<sup>1</sup></u>	<u>(7,466)<sup>2</sup></u>	<u>(7,229)<sup>3</sup></u>	<u>(7,172)<sup>4</sup></u>	<u>(7,857)<sup>5</sup></u>
<b>Railroad Retirement:</b>					
<i>Revenue (Contributions and Earmarked Taxes) from:</i>					
Participants who have attained eligibility .....	7	6	5	5	5
Participants who have not attained eligibility .....	56	46	47	48	43
Future participants .....	78	65	66	70	54
All current and future participants .....	<u>141</u>	<u>117</u>	<u>118</u>	<u>123</u>	<u>102</u>
<i>Expenditures for Scheduled Future Benefits for:</i>					
Participants who have attained eligibility .....	(119)	(109)	(105)	(102)	(97)
Participants who have not attained eligibility .....	(95)	(86)	(88)	(91)	(88)
Future participants .....	(34)	(28)	(27)	(30)	(26)
All current and future participants .....	<u>(248)</u>	<u>(223)</u>	<u>(220)</u>	<u>(223)</u>	<u>(212)</u>
<i>Present value of future expenditures in excess of future revenue</i> <sup>7</sup> .....	<u>(107)<sup>1</sup></u>	<u>(106)<sup>2</sup></u>	<u>(103)<sup>3</sup></u>	<u>(100)<sup>4</sup></u>	<u>(109)<sup>5</sup></u>
<b>Black Lung (Part C):</b>					
<i>Present value of future revenue in excess of future expenditures</i> <sup>8</sup> .....	<u>5<sup>9</sup></u>	<u>5<sup>10</sup></u>	<u>6<sup>11</sup></u>	<u>6<sup>12</sup></u>	<u>5<sup>13</sup></u>
<b>Total present value of future expenditures in excess of future revenue</b> .....	<u><u>(38,554)</u></u>	<u><u>(33,830)</u></u>	<u><u>(30,857)</u></u>	<u><u>(45,878)</u></u>	<u><u>(42,970)</u></u>

Totals may not equal the sum of components due to rounding.

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statements of Social Insurance (Note 26), continued  
Present Value of Long-Range (75 Years, except Black Lung) Actuarial Projections**

(In billions of dollars)	2012	2011	2010	2009	2008
<b>Social Insurance Summary:</b> <sup>14</sup>					
<i>Participants who have attained eligibility age:</i>					
Revenue (e.g., Contributions and earmarked taxes) .....	1,970	1,737	1,628	1,427	1,333
Expenditures for scheduled future benefits .....	(16,662)	(14,688)	(13,661)	(13,262)	(12,369)
Present value of future expenditures in excess of future revenue .....	(14,692)	(12,951)	(12,033)	(11,835)	(11,036)
<i>Participants who have not attained eligibility age:</i>					
Revenue (e.g., Contributions and earmarked taxes) .....	36,024	33,620	32,263	30,621	29,851
Expenditures for scheduled future benefits .....	(72,936)	(66,942)	(63,287)	(70,931)	(67,950)
Present value of future expenditures in excess of future revenue .....	(36,912)	(33,322)	(31,024)	(40,310)	(38,099)
<b>Closed-group – Total present value of future expenditures in excess of future revenue.....</b>	<b>(51,604)</b>	<b>(46,272)</b>	<b>(43,057)</b>	<b>(52,145)</b>	<b>(49,135)</b>
<i>Future participants:</i>					
Revenue (e.g., Contributions and earmarked taxes) .....	30,639	29,037	28,075	25,491	24,743
Expenditures for scheduled future benefits .....	(17,589)	(16,594)	(15,875)	(19,224)	(18,578)
Present value of future revenue in excess of future expenditures .....	13,050	12,443	12,200	6,267	6,165
<b>Open-group – Total present value of future expenditures in excess of future revenue.....</b>	<b>(38,554)</b>	<b>(33,830)</b>	<b>(30,857)</b>	<b>(45,878)</b>	<b>(42,970)</b>

<sup>1</sup> The projection period is 1/1/2012-12/31/2086 and the valuation date is 1/1/2012.

<sup>2</sup> The projection period is 1/1/2011-12/31/2085 and the valuation date is 1/1/2011.

<sup>3</sup> The projection period is 1/1/2010-12/31/2084 and the valuation date is 1/1/2010.

<sup>4</sup> The projection period is 1/1/2009-12/31/2083 and the valuation date is 1/1/2009.

<sup>5</sup> The projection period is 1/1/2008-12/31/2082 and the valuation date is 1/1/2008.

<sup>6</sup> These amounts represent the present value of the future transfers from the General Fund of the Treasury to the Supplementary Medical Insurance Trust Fund. These future intragovernmental transfers are included as income in both HHS' and the Centers for Medicare & Medicaid Services' Financial Reports but are not income from the Governmentwide perspective of this report.

<sup>7</sup> These amounts approximate the present value of the future financial interchange and the future advances from the General Fund of the Treasury to the Social Security Equivalent Benefit Account and future repayments from the Social Security Equivalent Benefit Account to the General Fund (see discussion of Railroad Retirement Program in the unaudited required supplementary information section of this report). They are included as income in the Railroad Retirement Financial Report but are not income from the Governmentwide perspective of this report.

<sup>8</sup> Does not include interest expense accruing on the outstanding debt.

<sup>9</sup> The projection period is 9/30/2012-9/30/2040 and the valuation date is 9/30/2012.

<sup>10</sup> The projection period is 9/30/2011-9/30/2040 and the valuation date is 9/30/2011.

<sup>11</sup> The projection period is 9/30/2010-9/30/2040 and the valuation date is 9/30/2010.

<sup>12</sup> The projection period is 9/30/2009-9/30/2040 and the valuation date is 9/30/2009.

<sup>13</sup> The projection period is 9/30/2008-9/30/2040 and the valuation date is 9/30/2008.

<sup>14</sup> Participants for the Social Security and Medicare programs are assumed to be the "closed-group" of individuals who are at least 15 years of age at the start of the projection period, and are participating as either taxpayers, beneficiaries, or both.

Totals may not equal the sum of components due to rounding.

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statement of Changes in Social Insurance Amounts  
for the Year Ended September 30, 2012 (Note 26)**

(In billions of dollars)	<b>Social Security</b>	<b>Medicare HI</b>	<b>Medicare SMI</b>	<b>Other (e.g. Railroad Retirement)</b>	<b>Total</b>
Net present value (NPV) of future revenue less future expenditures for current and future participants (the "open group") over the next 75 years, beginning of the year .....	(9,157)	(3,252)	(21,320)	(101)	(33,830)
Reasons for changes in the NPV during the year:					
Changes in valuation period .....	(473)	(125)	(1,013)	(2)	(1,613)
Changes in demographic data and assumptions .....	(140)	(97)	752	3	518
Changes in economic data and assumptions .....	(1,037)	-	-	(2)	(1,039)
Changes in law or policy .....	-	153	40	-	193
Changes in methodology and programmatic data .....	(471)	-	-	-	(471)
Changes in economic and other health care assumptions .....	-	(2,546)	(55)	-	(2,601)
Change in projection base .....	-	286	3	-	289
Net change in open group measure .....	(2,121)	(2,329)	(273)	(1)	(4,724)
Open group measure, end of year.....	<u>(11,278)</u>	<u>(5,581)</u>	<u>(21,593)</u>	<u>(102)</u>	<u>(38,554)</u>

Totals may not equal the sum of components due to rounding.

The accompanying notes are an integral part of these financial statements.

**United States Government  
Statement of Changes in Social Insurance Amounts  
for the Year Ended September 30, 2011 (Note 26)**

(In billions of dollars)	<b>Social Security</b>	<b>Medicare HI</b>	<b>Medicare SMI</b>	<b>Other (e.g. Railroad Retirement)</b>	<b>Total</b>
Net present value (NPV) of future revenue less future expenditures for current and future participants (the "open group") over the next 75 years, beginning of the year .....	(7,947)	(2,683)	(20,130)	(97)	(30,857)
Reasons for changes in the NPV during the year:					
Changes in valuation period .....	(436)	(112)	(968)	(2)	(1,518)
Changes in demographic data and assumptions .....	(688)	(112)	(59)	-	(859)
Changes in economic data and assumptions .....	(143)	-	-	(2)	(145)
Changes in law or policy .....	-	-	(14)	-	(14)
Changes in methodology and programmatic data .....	56	-	-	-	56
Changes in economic and other health care assumptions .....	-	185	(648)	-	(463)
Change in projection base .....	-	(531)	500	-	(31)
Net change in open group measure .....	(1,211)	(570)	(1,189)	(4)	(2,974)
Open group measure, end of year.....	(9,157)	(3,252)	(21,320)	(101)	(33,830)

Totals may not equal the sum of components due to rounding.

The accompanying notes are an integral part of these financial statements.



# United States Government Notes to the Financial Statements for the Years Ended September 30, 2012, and 2011

## Note 1. Summary of Significant Accounting Policies

### A. Reporting Entity

This *Financial Report* includes the financial status and activities of the executive branch, the legislative branch (the U.S. Senate and the U.S. House of Representatives report on a cash basis), and the judicial branch (which also reports on a cash basis) of the Government. The legislative and judicial branches report on a limited basis and are not required by law to submit financial statement information to Treasury. Appendix A of this report contains a list of organizations and agencies encompassed in the reporting entity for the *Financial Report*, as well as some organizations excluded from the reporting entity. Certain entities are excluded from the *Financial Report* because they are Government-Sponsored Enterprises (GSEs), such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Other entities are excluded from the *Financial Report* because their activities are not included in the Federal budget, such as the Thrift Savings Fund and the Board of Governors of the Federal Reserve System.

During fiscal year 2008, the Government began a number of additional emergency economic measures relating to the economy that involved various financing programs. Key initiatives effective beginning in fiscal year 2008 involved programs concerning Fannie Mae and Freddie Mac (GSEs), provision of a credit facility for GSEs and Federal Home Loan Banks, purchase of Mortgage-Backed Securities (MBS), and setup of a Money Market Guarantee Program (see Note 1.J—Investments in and Liabilities to Government-Sponsored Enterprises and Note 11—Investments in and Liabilities to Government-Sponsored Enterprises). The Emergency Economic Stabilization Act of 2008 (EESA) 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) (see Note 5—TARP Direct Loans and Equity Investments, Net).

Following U.S. Generally Accepted Accounting Principles for Federal entities (U.S. Generally-Accepted Accounting Principles (U.S. GAAP)), the Government has not consolidated into its financial statements the assets, liabilities, or results of operations of any financial organization or commercial entity in which Treasury holds either a direct, indirect, or beneficial equity investment. Even though some of the equity investments are significant, under Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, these entities meet the criteria of paragraph 50 and do not appear in the Federal budget section “Federal Programs by Agency and Account.” As such, these entities are not consolidated into the financial reports of the Government. However, the values of the investment in such entities are presented on the balance sheet.

Material intragovernmental transactions are eliminated in consolidation, except as described in the Other Accompanying Information—Unmatched Transactions and Balances (see Note 1.T). The financial reporting period ends September 30 and is the same as used for the annual budget.

## B. Basis of Accounting and Revenue Recognition

These financial statements were prepared using U.S. GAAP, primarily based on Statement of Federal Financial Accounting Standards (SFFAS). Under these principles:

- Expenses are generally recognized when incurred.
- Nonexchange revenues, including taxes, duties, fines, and penalties, are recognized when collected and adjusted for the change in net measurable and legally collectable amounts receivable. Related refunds and other offsets, including those that are measurable and legally payable, are netted against nonexchange revenue.
- Exchange (earned) revenues are recognized when the Government provides goods and services to the public for a price. Exchange revenues include user charges such as admission to Federal parks and premiums for certain Federal insurance.

The basis of accounting used for budgetary purposes, which is primarily on a cash and obligation basis and follows budgetary concepts and policies, differs from the basis of accounting used for the financial statements which follow U.S. GAAP. See the Reconciliations of Net Operating Cost and Unified Budget Deficit in the Financial Statements section.

The basis of accounting used and the detail of the basis for the Statement of Social Insurance (SOSI) and the Statement of Changes in Social Insurance Amounts are covered in Note 26—Social Insurance.

### New Standards Issued and Not Yet Implemented

The Federal Accounting Standards Advisory Board (FASAB) issued the following new standards that are applicable to the *Financial Report of the United States Government* (FR), but are not yet implemented at the Governmentwide level for fiscal year 2012:

- In July 2011, FASAB issued SFFAS No. 41, *Deferral of the Effective Date of SFFAS 38, Accounting for Federal Oil and Gas Resources*. SFFAS No. 38 requires the value of the federal government's estimated petroleum royalties from the production of federal oil and gas proved reserves to be reported in a schedule of estimated federal oil and gas petroleum royalties. In addition, this standard requires the value of estimated petroleum royalty revenue designated for others to be reported in a schedule of estimated federal oil and gas petroleum royalties to be distributed to others. These schedules are to be presented in required supplementary information (RSI) as part of a discussion of all significant federal oil and gas resources under management by the entity. SFFAS No. 41 amends the effective date of SFFAS No. 38 to fiscal year 2013. The specific impact of implementing the new standard has not yet been determined.
- In April 2012, FASAB issued SFFAS No. 42, *Deferred Maintenance and Repairs, Amending SFFAS No. 6, 14, 29, and 32*. SFFAS No. 42 replaces the definition, measurement and reporting requirements for deferred maintenance and repairs established in SFFAS No. 6. SFFAS No. 42 paragraph 19 rescinds the current Governmentwide disclosures required for deferred maintenance established in SFFAS 32 paragraph 24. SFFAS 42 paragraph 16 requires the Governmentwide financial statements to disclose as RSI a description of what constitutes deferred maintenance and repairs (DM&R) and how it was measured; amounts of DM&R for each major category of property, plant and equipment; and a general reference to specific component entity reports for additional information. SFFAS No. 42 becomes effective in fiscal year 2015. The specific impact of implementing the new standard has not yet been determined.
- In June 2012, FASAB issued SFFAS No. 43, *Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked Funds*. SFFAS No. 43 changes the term "earmarked funds" to "funds from dedicated collections"; clarifies that at least one source of funds external to the federal government must exist for a fund to qualify as a fund from dedicated collections; and adds an explicit exclusion for any fund established to account for pensions, other retirement benefits, other postemployment or other benefits provided for federal employees (civilian and military). In addition, the disclosure may present combined or consolidated amounts and the presentation must be labeled accordingly. SFFAS No. 43 becomes effective in fiscal year 2013, with early adoption not permitted. Further, when implemented in fiscal year 2013, SFFAS No. 43 requires that prior period (i.e., fiscal year 2012) amounts displayed on the face of the financial statements and disclosed in notes be restated. When implemented, SFFAS No. 43 is expected to have a material impact on the U.S. government's consolidated financial statements primarily due to the exclusion of certain funds currently reported as "earmarked funds", although the specific impact has not yet been determined.

## C. Loans Receivable, Mortgage-Backed Securities, and Loan Guarantee Liabilities, Net

Direct loans obligated and loan guarantees committed after fiscal year 1991 are reported based on the present value of the net cash flows estimated over the life of the loan or guarantee. The difference between the outstanding principal of the direct loans and the present value of their net cash inflows is recognized as a subsidy cost allowance. The present value of estimated net cashflows of the loan guarantees is recognized as a liability for loan guarantees.

The subsidy expense for direct or guaranteed loans disbursed during a fiscal year is the present value of estimated net cashflows for those loans or guarantees. A subsidy expense also is recognized for modifications made during the year to loans and guarantees outstanding and for reestimates made as of the end of the fiscal year to the subsidy allowances or loan guarantee liability for loans and guarantees outstanding.

Direct loans obligated and loan guarantees committed before fiscal year 1992 are valued under two different methodologies within the Government: the allowance-for-loss method and the present-value method. Under the allowance-for-loss method, the outstanding principal of direct loans is reduced by an allowance for uncollectible amounts; the liability for loan guarantees is the amount the agency estimates would more likely than not require future cash outflow to pay default claims. Under the present-value method, the outstanding principal of direct loans is reduced by an allowance equal to the difference between the outstanding principal and the present value of the expected net cashflows. The liability for loan guarantees is the present value of expected net cash outflows due to the loan guarantees.

The MBS are treated similarly to direct loans made after fiscal year 1991, and the value of the Government's position and the associated credit subsidy requirements are determined based on the net present value of the securities' forecasted future cashflows. For more details on MBS, see Note 4—Loans Receivable, Mortgage-Backed Securities and Loan Guarantee Liabilities, Net.

## D. Accounts and Taxes Receivable

Accounts receivable represent claims to cash or other assets from entities outside the Government that arise from the sale of goods or services, duties, fines, certain license fees, recoveries, or other provisions of the law. Accounts receivable are reported net of an allowance for uncollectible accounts. An allowance is established when it is more likely than not the receivables will not be totally collected. The allowance method varies among the agencies in the Government and is usually based on past collection experience and is re-estimated periodically as needed. Methods include statistical sampling of receivables, specific identification and intensive analysis of each case, aging methodologies, and percentage of total receivables based on historical collection.

Taxes receivable consist primarily of uncollected tax assessments, penalties, and interest when taxpayers have agreed the amounts are owed or a court has determined the assessments are owed. The Balance Sheets do not include unpaid assessments when neither taxpayers nor a court have agreed that the amounts are owed (compliance assessments) or the Government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency (writeoffs). Taxes receivable are reported net of an allowance for the estimated portion deemed to be uncollectible. The allowance for doubtful accounts is based on projections of collectibles from a statistical sample of unpaid tax assessments.

## E. TARP Direct Loans and Equity Investments, Net

Troubled Asset Relief Program (TARP) equity investments are accounted for at fair value, which is defined as the estimated amount of proceeds that would be received if the equity investments were sold to a market participant in an orderly transaction. Consistent with the present value accounting concepts embedded in SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*, TARP direct loans and equity investments, net, disbursed and outstanding are recognized as assets at the net present value of their estimated future cashflows and outstanding asset guarantees are recognized as liabilities or assets at the net present value of their estimated future cashflows. Market risk is considered in the calculation and determination of the estimated net present values.

The subsidy allowance for TARP's direct loans and equity investments represents the difference between the face value of the outstanding direct loan and equity investment balance and the net present value of the expected future cashflows and is reported as an adjustment to the face value of the direct loan or equity investment.

The recorded subsidy allowance for a direct loan or equity investment is based on a set of estimated future cashflows.

The Government used the following methodologies for valuation of the TARP direct loans and equity investments:

- The estimated future cashflows for TARP direct loans were derived using analytical models that estimate the cashflows to and from the Government over the life of the loan. These cashflows include the scheduled principal, interest, and other payments to the Government, including estimated proceeds from equity interest obtained or additional notes. These models also include estimates of default and recoveries, incorporating the value of any collateral provided by the contract. The probability and timing of default and losses relating to a default are estimated by using applicable historical data when available, or publicly available proxy data, including credit rating agency historical performance data. The models include an adjustment for market risk which is intended to capture the risk of unexpected losses, but are not intended to represent fair value, i.e., the proceeds that would be expected to be received if the loans were sold to a market participant.
- TARP preferred stock cashflows are projected using an analytical model developed to incorporate the risk of losses associated with adverse events, such as failure of the institution or increases in market interest rates. The model estimates how cashflows vary depending on: (1) current interest rates, which may affect the decision whether to repay the preferred stock; and (2) the strength of a financial institution's assets. Inputs to the model include institution specific accounting data obtained from regulatory filings, an institution's stock price volatility, and historical bank failure information, as well as market prices of comparable securities trading in the market. The Government estimates the values and projects the cashflows of warrants using an option-pricing approach based on the current stock price and its volatility. Investments in common stock which are exchange traded are valued at the market price. The result of using market prices, either quoted prices for the identical asset or quoted prices for comparable assets, is that the equity investments are recorded at estimated fair value.

For more details on TARP, see Note 5—TARP Direct Loans and Equity Investments, Net.

## **F. Non-TARP Investments in American International Group, Inc.**

The Non-TARP investments in American International Group (AIG), Inc. are recorded at fair value and represent the Government's non-TARP holdings of AIG common stock. The value of the non-TARP investments in AIG is based on the market value of the Government's holdings of AIG common stock as of the reporting date. (See Note 6—Non-TARP Investments in American International Group, Inc., Note 1.I—Debt and Equity Securities, and Note 9—Debt and Equity Securities for further details.)

## **G. Inventories and Related Property**

Inventory is tangible personal property that is (1) held for sale, principally to Federal agencies, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. SFFAS No. 3, *Accounting for Inventory and Related Property*, requires inventories held for sale and held in reserve for future sale within the Government to be valued using either historical cost or latest acquisition cost (LAC). Historical cost methods include first-in-first-out, weighted average, and moving average. When LAC methods are used, the inventory is revalued periodically and an allowance account should be established for unrealized holding gains and losses.

The Department of Defense (DOD) holds the majority of the inventories within the Government and uses standard price and moving average cost methods for valuing most of its inventory. To a lesser degree, DOD also uses LAC methods adjusted for holding gains and losses to approximate the historical cost of resale inventory items remaining in its legacy system. DOD is continuing to transition inventories currently accounted for under the LAC

methods, to be accounted for under the moving average cost methods, however, DOD still has supportability of inventory valuation issues.

When using historical cost valuation, estimated repair costs reduce the value of inventory held for repair. Excess, obsolete, and unserviceable inventories are valued at estimated net realizable value. When latest acquisition cost is used to value inventory held for sale, it is adjusted for holding gains and losses in order to approximate historical cost.

Related property includes commodities, seized monetary instruments, forfeited and foreclosed property, raw materials and work in process. Operating materials and supplies are valued at historical cost, latest acquisition cost, and standard price using the purchase and consumption method of accounting. Operating materials and supplies that are valued at latest acquisition cost and standard pricing are not adjusted for holding gains and losses.

## H. Property, Plant, and Equipment

PP&E consists of tangible assets including buildings, equipment, construction in progress, and internal use software, assets acquired through capital leases, including leasehold improvements, and other assets used to provide goods and services.

PP&E used in Government operations are carried at acquisition cost, with the exception of DOD military equipment (e.g., ships, aircraft, combat vehicles, and weapons) and some National Aeronautics and Space Administration (NASA) equipment. DOD military equipment is valued at estimated historical costs, which are calculated using internal DOD records. DOD identified the universe of military equipment by accumulating information relating to program funding and associated military equipment, equipment useful life, and program acquisitions and disposals to create a baseline. The equipment baseline is updated using expenditure information and information related to acquisition and logistics to identify acquisitions and disposals. NASA also uses estimates of historical cost to value some of its equipment for which historical cost information is not readily available, such as components of the International Space Station.

All PP&E is capitalized if the acquisition costs (or estimated acquisition cost for DOD) are in excess of capitalization thresholds that vary considerably between the Federal entities. Depreciation and amortization expense applies to PP&E reported on the balance sheets except for land, unlimited duration land rights and construction in progress. Depreciation and amortization are recognized using the straight-line method over the estimated useful lives of the assets. All property, plant, and equipment are assigned useful lives depending on their category and vary considerably between the Federal entities. The cost of acquisition, betterment, or reconstruction of all multi-use heritage assets is capitalized as general PP&E and is depreciated. Construction in progress is used for the accumulation of the cost of construction or major renovation of fixed assets during the construction period. The assets are transferred out of construction in progress when the project is substantially completed. Internal use software includes purchased commercial off-the-shelf software, contractor-developed software, and software internally developed.

For financial reporting purposes, other than multi-use heritage assets, stewardship assets are not recorded as part of PP&E. Stewardship Assets consist of public domain land (Stewardship Land) and Heritage Assets. Examples of stewardship land include national parks, wildlife refuges, national forests, and other lands of national and historical significance. Heritage assets include national monuments, and historical sites that among other characteristics are of historical, natural, cultural, educational or artistic significance. Stewardship land and most heritage assets are considered priceless and irreplaceable, and as such they are measured in physical units with no financial value assigned to them. Some heritage assets have been designated as multi-use heritage assets, for example the White House, the predominant use of which is in government operations. For more details on stewardship assets, see Note 27—Stewardship Land and Heritage Assets.

## I. Debt and Equity Securities

Debt and equity securities are classified as held-to-maturity, available-for-sale, and trading. Held-to-maturity debt and equity securities are reported at amortized cost, net of unamortized premiums and discounts. Available-for-sale debt and equity securities are reported at fair value. Trading debt and equity securities are reported at fair value.

## J. Investments in and Liabilities to Government-Sponsored Enterprises

The senior preferred stock liquidity preference (preferred stock) and associated common stock warrant (warrant(s)) in GSEs are presented at their fair value as permitted by Office of Management and Budget (OMB) Circular No. A-136. This Circular includes language that generally requires agencies to value non-Federal investments at acquisition cost, and also permits the use of other measurement basis, such as fair value, in certain situations. Treasury performs annual valuations, as of September 30th, to provide a “sufficiently reliable” estimate of the outstanding commitments in order for Treasury to record the remaining liability in accordance with SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. The valuations incorporated various forecasts, projections, and cashflow analyses to develop an estimate of the potential liability. Annual valuations are performed, as of September 30, of the preferred stock and warrants and any changes in valuation, including impairment, are recorded and disclosed in accordance with SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*. Since the valuation is an annual process, the changes in valuation of the preferred stock and warrants are deemed usual and recurring. Accordingly, changes in valuation are recorded as an exchange transaction which is either an expense or revenue. Since the costs of preferred stock and warrants are exchange transactions, any change in valuation is also recorded as an exchange transaction.

The Federal Housing Finance Regulatory Reform Act of 2008 established the Federal Housing Finance Agency (FHFA), which was created to enhance authority over the GSEs and provide the Secretary of the Treasury with certain authorities intended to ensure the financial stability of the GSEs. Treasury entered into a Senior Preferred Stock Purchase Agreement (SPSPA) with each GSE. Based on U.S. GAAP, these contingent liquidity commitments, predicated on the future occurrence of any shareholders’ deficits of the GSEs, at the end of any reporting quarter are potential liabilities of Treasury. The potential liabilities to the GSEs are assessed annually and recorded at the gross amount, without the consideration of the increase in preferred stock liquidity preference, future dividend payments, or future commitment fees due to the uncertainties involved. For more detailed information on investments and liabilities of GSEs, refer to Note 11—Investments in and Liabilities to Government-Sponsored Enterprises.

## K. Federal Debt

Accrued interest on Treasury securities held by the public is recorded as an expense when incurred, instead of when paid. Certain Treasury securities are issued at a discount or premium. These discounts and premiums are amortized over the term of the security using an interest method for all long-term securities and the straight line method for short-term securities. Treasury also issues Treasury Inflation-Protected Securities (TIPS). The principal for TIPS is adjusted daily over the life of the security based on the Consumer Price Index (CPI) for all Urban Consumers.

## L. Federal Employee and Veteran Benefits Payable

Generally, Federal employee and veteran benefits payable are recorded during the time employee services are rendered. The related liabilities for defined benefit pension plans, veterans’ compensation and burial benefits, post-retirement health benefits, life insurance benefits, and Federal Employees’ Compensation Act benefits are recorded at estimated present value of future benefits, less any estimated present value of future normal cost contributions. The estimated present value for veterans’ pension benefits is disclosed but is not included in the Federal employee and veteran benefits payable line. These benefits are expensed when services are provided.

Normal cost is the portion of the actuarial present value of projected benefits allocated as an expense for employee services rendered in the current year. Actuarial gains and losses (and prior service cost, if any) are recognized immediately in the year they occur, without amortization.

Gains and losses from changes in long-term assumptions used to estimate Federal employee pensions, Other Retirement Benefits (ORB), and Other Postemployment Benefits (OPEB) liabilities are reflected separately on the Statement of Net Cost and the components of the expense related to Federal employee pension, ORB, and OPEB

liabilities are disclosed in Note 15—Federal Employee and Veteran Benefits Payable as prescribed by SFFAS No. 33. In addition, SFFAS No. 33 also provides a standard for selecting the discount rate assumption for present value estimates of Federal employee pension, ORB, and OPEB liabilities.

## **M. Environmental and Disposal Liabilities**

Environmental and disposal liabilities are recorded at the estimated current cost of removing, containing, treating, and/or disposing of radioactive waste, hazardous waste, chemical and nuclear weapons, and other environmental contaminations, assuming the use of current technology. Hazardous waste is a solid, liquid, or gaseous waste that, because of its quantity or concentration, presents a potential hazard to human health or the environment. Remediation consists of removal, decontamination, decommissioning, site restoration, site monitoring, closure and post-closure cost, treatment, and/or safe containment. Where technology does not exist to clean up radioactive or hazardous waste, only the estimable portion of the liability, typically monitoring and safe containment is recorded.

## **N. Insurance and Guarantee Program Liabilities**

Insurance and guarantee programs provide protection to individuals or entities against specified risks except for those specifically covered by Federal employee and veteran benefits, social insurance, and loan guarantee programs. Insurance and guarantee program funds are commonly held in revolving funds in the Government and losses sustained by participants are paid from these funds. Many of these programs receive appropriations to pay excess claims and/or have authority to borrow from the Treasury. The values of insurance and guarantee program liabilities are particularly sensitive to changes in underlying estimates and assumptions. Insurance and guarantee programs with recognized liabilities in future periods (i.e., liabilities that extend beyond one year) are reported at their actuarial present value.

## **O. Deferred Maintenance and Repairs**

Deferred maintenance and repairs is maintenance and repairs that were not performed when they should have been or scheduled maintenance and repairs that were delayed or postponed. Maintenance is the act of keeping fixed assets in acceptable condition, including preventative maintenance, normal repairs, and other activities needed to preserve the assets, so they continue to provide acceptable service and achieve their expected life. Maintenance and repairs exclude activities aimed at expanding the capacity of assets or otherwise upgrading them to serve needs different from those originally intended. Deferred maintenance and repairs expenses are not accrued in the Statements of Net Cost or recognized as liabilities on the Balance Sheets. However, deferred maintenance and repairs information is disclosed in the Unaudited Required Supplementary Information section of this report.

## **P. Contingent Liabilities**

Liabilities for contingencies are recognized on the Balance Sheets when both:

- A past transaction or event has occurred, and
- A future outflow or other sacrifice of resources is probable and measurable.

The estimated contingent liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, then that amount is recognized. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range is recognized and the range is disclosed.

Contingent liabilities that do not meet the above criteria for recognition, but for which there is at least a reasonable possibility that a loss may have been incurred, are disclosed in Note 22—Contingencies.

## Q. Commitments

In the normal course of business, the Government has a number of unfulfilled commitments that may require the use of its financial resources. Note 23—Commitments describes the components of the Government's actual commitments that need to be disclosed because of their nature and/or their amount. They include long-term leases, undelivered orders, and other commitments.

## R. Social Insurance

A liability for social insurance programs (Social Security, Medicare, Railroad Retirement, Black Lung, and Unemployment) is recognized for any unpaid amounts currently due as of the reporting date. No liability is recognized for future benefit payments not yet due. For further information, see the Unaudited Required Supplementary Information—Social Insurance section, and Note 26—Social Insurance.

## S. Related Party Transactions

### Federal Reserve System

The Federal Reserve System (FR System) was created by Congress under the Federal Reserve Act of 1913. The FR System consists of the Federal Reserve Board of Governors (Board), the Federal Open Market Committee (FOMC), and the FRBs. Collectively, the FR System serves as the nation's central bank and is responsible for formulating and conducting monetary policy, issuing and distributing currency (Federal Reserve Notes), supervising and regulating financial institutions, providing nationwide payments systems (including large-dollar transfers of funds, automated clearinghouse ACH operations, and check collection), providing certain financial services to federal agencies and fiscal principals, and serving as the Government's bank. Monetary policy includes actions undertaken by the FR System that influence the availability and cost of money and credit as a means of helping to promote national economic goals. The FR System also conducts operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out its central bank responsibilities. The FR System is not included in the federal budget. It is considered an independent central bank, and its decisions are not ratified by the executive branch of the Federal Government.

The Government interacts with the FRBs in a variety of ways, including the following:

- The FRBs serve as the Government's fiscal agent and depository, executing banking and other financial transactions on the Government's behalf. The Government reimburses the FRBs for these services, the cost of which is included on the Statements of Net Cost
- The FRBs hold Treasury and other federal securities in the FRBs' System Open Market Account (SOMA) for the purpose of conducting monetary policy (Note 14—Federal Debt Securities Held by the Public and Accrued Interest)
- The FRBs hold gold certificates issued by the Government in which the certificates are collateralized by gold (Note 2—Cash and Other Monetary Assets)
- The FRBs hold Special Drawing Rights (SDR) certificates issued by the Government which are collateralized by SDRs (see Note 2—Cash and Other Monetary Assets)
- The FRBs are required by Board policy to transfer their excess earnings to the Government

The Government also consults with the FR System on matters affecting the economy and certain financial stability activities (Note 4—Loans Receivable, Mortgage-Backed Securities, and Loan Guarantee Liabilities, Net, Note 5—Troubled Asset Relief Program (TARP)—Direct Loans and Equity Investments, and Note 6—Non-TARP Investments in American International Group, Inc.). The above financial activities involving the Government are accounted for and disclosed in the Government consolidated financial statements. In accordance with SFFAC No. 2, Entity and Display, the FR System's assets, liabilities, and operations are not consolidated into the Government's financial statements, and are, therefore, not a part of the reporting entity.



### **Federal Reserve System Structure**

The Board is an independent organization governed by seven members who are appointed by the President and confirmed by the Senate. The full term of a Board member is 14 years, and the appointments are staggered so that one term expires on January 31 of each even-numbered year. The Board has a number of supervisory and regulatory responsibilities for institutions including, among others, state-chartered banks that are members of the FR System, bank holding companies, and savings and loan holding companies. In addition, the Board has general supervisory responsibilities for the 12 FRBs, and issues currency (Federal Reserve Notes) to the FRBs for distribution. The FOMC is comprised of the seven Board members and five of the 12 FRB presidents, and is charged with formulating and conducting monetary policy primarily through open market operations (the purchase and sale of certain securities in the open market), the principal tool of national monetary policy. These operations affect the amount of reserve balances available to depository institutions, thereby influencing overall monetary and credit conditions. The 12 FRBs are chartered under the Federal Reserve Act, which requires each member bank to own the capital stock of its FRB. Supervision and control of each FRB is exercised by a board of directors, of which three are appointed by the Board of Governors of the FR System, and six are elected by their member banks.

The FRBs participate in formulating and conducting monetary policy, distribute currency and coin, and serve as fiscal agents for the Government, other federal agencies and fiscal principals. Additionally, the FRBs provide short-term loans to depository institutions and loans to participants in programs or facilities with broad-based eligibility in unusual and crucial circumstances when approved by the Board.

### **Federal Reserve System Assets and Liabilities**

The FRBs hold Treasury and other securities in the SOMA for the purpose of conducting monetary policy. Treasury securities held by the FRBs totaled \$1,646.8 billion and \$1,665.4 billion at September 30, 2012, and 2011, respectively (Note 14—Federal Debt Securities Held by the Public and Accrued Interest). These assets are generally subject to the same market (principally interest-rate) and credit risks as other financial instruments. In the open market, the FR System purchases and sells Treasury securities as a mechanism for controlling the money supply.

The FRBs have deposit liabilities with Treasury and depository institutions. The FRBs issue Federal Reserve Notes, the circulating currency of the United States, which are collateralized by the Treasury securities and other assets held by the FRBs. Financial and other information concerning the FR System, including financial statements for the Board and the FRBs, may be obtained at <http://www.federalreserve.gov>.

### **FRB Residual Earnings Transferred to the Government**

FRBs generate income from interest earned on securities, reimbursable services provided to federal agencies, and the provision of priced services to depository institutions, as specified by the Monetary Control Act of 1980. Although the FRBs generate earnings from carrying out open market operations (via the earnings on securities held in the SOMA account), their execution of these operations is for the purpose of accomplishing monetary policy rather than generating earnings. Each FRB is required by Board policy to transfer to the Government its residual (or excess) earnings, after providing for the cost of operations, payment of dividends, and reservation of an amount necessary to equate surplus with paid-in capital. These residual earnings may vary due to, among other things, changes in the SOMA balance levels that may occur in conducting monetary policy. The FRB residual earnings of \$82.0 billion and \$82.5 billion for fiscal years ended September 30, 2012, and 2011, respectively, are reported as other taxes and receipts on the Statements of Operations and Changes in Net Position. Accounts and taxes receivables, net, includes a receivable for FRB's residual earnings which represents the earnings due to the Treasury General Fund as of September 30, but not collected by the Treasury General Fund until after the end of the month. As of September 30, 2012, and 2011, interest receivable on FRB's residual earnings are \$2.3 billion and \$1.6 billion, respectively (Note 3—Accounts and Taxes Receivables, Net).

### **Other Related Parties**

The Government generally does not guarantee payment of the liabilities of GSEs such as Fannie Mae, Freddie Mac, or the Federal Home Loan Banks, which are privately owned. For further details regarding investments in or liabilities to Fannie Mae and Freddie Mac, see Note 11—Investments in and Liabilities to Government-Sponsored Enterprises.

The Secretary of Transportation has possession of two long term notes with the National Railroad Passenger Service Corporation (more commonly referred to as Amtrak). The first note is for \$4 billion and matures in 2975 and the second note is for \$1.1 billion and matures in 2082 with renewable 99 year terms. Interest is not accruing on these notes as long as the current financial structure of Amtrak remains unchanged. If the financial structure of Amtrak changes, both principal and accrued interest are due and payable. The Department of Transportation (DOT) does not

record the notes in its financial statements because the present value of the notes was immaterial at September 30, 2012. These notes were discounted according to rates published in OMB M-11-12, Appendix C, *Discount Rates for Cost Effectiveness Lease Purchase and Related Analyses* with maturity dates of 2975 and 2082.

In addition, DOT has possession of all the preferred stock shares (109.4 million) of Amtrak. Congress, through DOT, has continued to fund Amtrak since approximately 1972; originally through grants, then, beginning in 1981, through the purchase of preferred stock, and then through grants again after 1997. The Amtrak Reform and Accountability Act of 1997 changed the structure of the preferred stock by rescinding the voting rights with respect to the election of the Board of Directors and by eliminating the preferred stock's liquidation preference over the common stock. The Act also eliminated further issuance of preferred stock to DOT. DOT does not record the Amtrak preferred stock in its financial statements because, under the Corporation's current financial structure, the preferred shares do not have a liquidation preference over the common shares, the preferred shares do not have any voting rights, and dividends are neither declared nor in arrears.

Amtrak is not a department, agency or instrumentality of the Government or DOT. The nine members of Amtrak's Board of Directors are appointed by the President of the United States and are subject to confirmation by the U.S. Senate. Once appointed, Board members, as a whole, act independently without the consent of the Government or any of its officers to set Amtrak policy, determine its budget and decide operational issues. The Secretary of Transportation is statutorily appointed to the nine-member Board. Traditionally, the Secretary of Transportation has designated the Administrator of the Federal Railroad Administration to represent the Secretary at Board meetings.

The Export-Import Bank of the United States (Ex-Im Bank) has contractual agreements with the Private Export Funding Corporation (PEFCO). PEFCO, which is owned by a consortium of private-sector banks, industrial companies and financial services institutions, makes medium-term and long-term fixed-rate and variable-rate loans to foreign borrowers to purchase U.S.-made equipment when such loans are not available from traditional private sector lenders on competitive terms. Ex-Im Bank's credit and guarantee agreement with PEFCO extends through December 31, 2020. Through its contractual agreements with PEFCO, Ex-Im Bank exercises a broad measure of supervision over PEFCO's major financial management decisions, including approval of both the terms of individual loan commitments and the terms of PEFCO's long-term debt issues, and is entitled to representation at all meetings of PEFCO's board of directors, advisory board and its exporters' council.

The contractual agreements provide that Ex-Im Bank will (1) guarantee the due and punctual payment of principal and interest on export loans made by PEFCO and (2) guarantee the due and punctual payment of interest on PEFCO's long-term secured debt obligations when requested by PEFCO. Related to the amounts for Ex-Im Bank as shown in Note 4—Loans Receivable, Mortgage-Backed Securities, and Loan Guarantee Liabilities, Net, these guarantees to PEFCO, aggregating \$6.1 billion and \$5.3 billion at September 30, 2012 and 2011, respectively, are included within the principal amounts guaranteed by the United States. The allowance related to these transactions is included within the guaranteed loan liability. Ex-Im Bank received fees totaling \$0.03 billion in both fiscal years 2012 and 2011 for the agreements, which are included as earned revenue on the Statements of Net Cost.

## T. Unmatched Transactions and Balances

The reconciliation of the change in net position requires that the difference between ending and beginning net position equals the excess of revenues over net cost, plus or minus prior-period adjustments.

The unmatched transactions and balances are needed to bring the change in net position into balance. The primary factors affecting this out of balance situation are:

- Unmatched intragovernmental transactions and balances between Federal agencies,
- General Fund transactions, and
- Timing differences and errors in Federal agencies' reporting.

Refer to the Other Accompanying Information—Unmatched Transactions and Balances for detailed information.

## U. Derivatives

A derivative is a financial instrument or other contract with all three of the following characteristics:

- It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether a settlement is required.
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional (or face) amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

The accounting for derivative instruments are governed by FASB Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*, which aims to highlight to financial statement users additional disclosures on an entity's objectives in its use of derivatives and the method of accounting for such financial instruments. This standard requires that entities with derivatives disclose the following:

- How and why an entity uses derivatives,
- How derivatives and related hedged items are accounted for under this accounting standard, and
- How derivatives and related hedged items affect an entity's financial statements.

For further information, see Note 10—Derivatives.

## V. Reclassifications

Certain amounts were reclassified in the fiscal year 2011 consolidated statement of net cost. The fiscal year 2011 allocation of federal employee benefit expenses from the OPM to all other agencies did not include an allocation for the benefit expense to the U.S. Postal Service (USPS). The fiscal year 2011 allocation of federal benefit expenses now includes an allocation of these expenses to USPS and resulted in an increase of USPS gross and net cost of \$5.5 billion, as there was no change to the fiscal year 2011 USPS earned revenue amount. This \$5.5 billion gross cost was reclassified from all the remaining agencies' gross costs to reflect the benefit expense allocation to USPS.

Certain amounts were reclassified in the fiscal year 2011 reconciliation from net operating cost to the unified budget deficit. As a result of additional information obtained in fiscal year 2012 for credit reform and other loan activities, \$6.2 billion included in the "all other" aggregate reconciling line item was reclassified to the credit reform and other loan activities reconciling line item.

Non-TARP Investment in American International Group, Inc. amounts were reclassified to debt and equity securities. See Note 9—Debt and Equity Securities.

The calculation and presentation of the components of the reconciliation of veterans' compensation and burial benefits liabilities shown in Note 15—Federal Employee and Veteran Benefits Payable were modified for fiscal year 2012 to better align the presentation of these veterans benefits liabilities with those of other agencies for improved consistency in government-wide OPEB reporting. As a result, the fiscal year 2011 presentation was also modified to conform to the fiscal year 2012 presentation. Neither the fiscal year 2011 ending liability or the related benefits expense changed as a result of this presentation change.

For fiscal years 2012 and 2011, one fund in each year that was previously reported as an earmarked fund was reclassified to non earmarked funds and recorded as a prior period adjustment. See Note 21—Prior Period Adjustments, for a prior period adjustment in fiscal year 2012 resulting from a change in accounting principle.

## W. Fiduciary Activities

Fiduciary activities are the collection or receipt, and the management, protection, accounting, investment and disposition by the Government of cash or other assets in which non-Federal individuals or entities have an ownership interest that the Government must uphold. Fiduciary cash and other fiduciary assets are not assets of the Government and are not recognized on the Balance Sheet. See Note 25—Fiduciary Activities, for further information.

## X. Use of Estimates

The Government has made certain estimates and assumptions relating to the reporting of assets, liabilities, revenues, expenses, and the disclosure of contingent liabilities to prepare these financial statements. There are a large number of factors that affect these assumptions and estimates, which are inherently subject to substantial uncertainty arising from the likelihood of future changes in general economic, regulatory and market conditions. As such, actual results will differ from these estimates and such differences may be material.

Significant transactions subject to estimates include loans receivable and MBS, TARP direct loans and equity investments; investments in other non-Federal securities (including GSEs and foreign and domestic public entities) and related impairment, if any; tax receivables; loan guarantees; depreciation; liability for liquidity commitment (GSEs); actuarial liabilities; contingent legal liabilities; environmental liabilities; credit reform subsidy costs; and insurance and guarantee program liabilities.

The Government recognizes the sensitivity of credit reform modeling to slight changes in some model assumptions and uses regular review of model factors, statistical modeling, and annual reestimates to reflect the most accurate cost of the credit programs to the U.S. Government. Two of the emergency economic programs that the Government implemented in the latter part of September 2008, the purchase program for MBS and the GSE credit line facility, are accounted for pursuant to the provisions of credit reform and the use of estimates as dictated by the *Federal Credit Reform Act of 1990* (FCRA). FCRA loan receivables and loan guarantees are disclosed in Note 4—Loans Receivable, Mortgage-Backed Securities, and Loan Guarantee Liabilities, Net. Additionally, all TARP credit activity, including investments in common and preferred stock and loans and asset guarantees, are also subject to credit reform accounting (see Note 5—TARP Direct Loans and Equity Investments, Net).

The forecasted future cashflows used to determine credit reform amounts as of September 30, 2012, and 2011, are sensitive to slight changes in model assumptions, such as general economic conditions, specific stock price volatility of the entities in which the Government has an equity interest, estimates of expected default, and prepayment rates. Forecasts of future financial results have inherent uncertainty and the TARP Direct Loans and Equity Investments, Net line item as of September 30, 2012, and 2011, is reflective of relatively illiquid, troubled assets whose values are particularly sensitive to future economic conditions and other assumptions.

The GSE senior preferred stock purchase agreements (SPSPAs) provide that the Government will make funding advances to the GSEs, if needed at the end of any quarter. The FHFA, acting as the conservator, determines that the liabilities of either GSE, individually, exceed its respective assets. Valuation analyses are performed to attempt to provide a “sufficiently reliable” estimate of the outstanding commitment which is recorded as a liability in accordance with SFFAS No. 5. As part of the valuation exercise, Treasury prepared a series of long-range forecasts through 2025 to determine the implied amount of total liability. In fiscal year 2012, the SPSPAs were amended. For more detailed information on investments and liabilities of GSEs and the amended SPSPAs, see Note 11—Investments in and Liabilities to Government-Sponsored Enterprises.

## Y. Credit Risk

Credit risk is the potential, no matter how remote, for financial loss from a failure of a borrower or a counterparty to perform in accordance with underlying contractual obligations. The Government takes on credit risk when it makes direct loans or credits to foreign entities or becomes exposed to institutions which engage in financial transactions with foreign countries.

The Government also takes on credit risk related to committed but undisbursed direct loans, liquidity commitment to GSEs, the MBS portfolio, investments, loans, and asset guarantees of the TARP, guarantee of money market funds, and the Terrorism Risk Insurance Program. Except for the Terrorism Risk Insurance Program, these activities focus on the underlying problems in the credit markets, and the ongoing instability in those markets exposes the Government to potential unknown costs and losses. The extent of the risk assumed is described in more detail in the notes to the financial statements, and where applicable, is factored into credit reform models and reflected in fair value measurements.

## Note 2. Cash and Other Monetary Assets

### Cash and Other Monetary Assets as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
Unrestricted cash:		
Cash held by Treasury for Governmentwide operations .....	79.2	49.8
Other .....	5.9	8.3
Restricted cash - Other .....	20.9	18.8
Total cash .....	<u>106.0</u>	<u>76.9</u>
International monetary assets .....	76.8	76.6
Gold and silver .....	11.1	11.1
Foreign currency .....	12.3	12.4
Total cash and other monetary assets .....	<u>206.2</u>	<u>177.0</u>

Unrestricted cash includes cash held by Treasury for Governmentwide operations (Operating Cash) and all other unrestricted cash held by the Federal agencies. Operating Cash represents balances from tax collections, other revenue, Federal debt receipts, and other various receipts net of cash outflows for budget outlays and other payments. Operating Cash includes balances invested with commercial depositories in Treasury Tax and Loan Accounts (including funds invested through the Term Investment Option program and the Repo Pilot program). Treasury checks outstanding are netted against Operating Cash until they are cleared by the Federal Reserve System. Other unrestricted cash not included in Treasury's Operating Cash balance includes balances representing cash, cash equivalents, and other funds held by agencies, such as undeposited collections, deposits in transit, demand deposits, amounts held in trust, imprest funds, and amounts representing the balances of petty cash. Operating Cash held by the Treasury increased by \$29.4 billion (an increase of approximately 60 percent) in fiscal year 2012 due to Treasury's investment and borrowing decisions to manage the balance and timing of the Government's cash position.

Restricted cash is restricted due to the imposition on cash deposits by law, regulation, or agreement. Restricted cash is primarily composed of cash held by the Executive Office of the President (EOP) Foreign Military Sales programs. The Foreign Military Sales program included \$20.1 billion and \$18.2 billion as of September 30, 2012, and 2011, respectively.

International monetary assets include the U.S. reserve position in the International Monetary Fund (IMF) and U.S. holdings of Special Drawing Rights (SDRs). The U.S. reserve position in the IMF is an interest-bearing claim on the IMF that includes the reserve asset portion of the financial subscription that the United States has paid in as part of its participation in the IMF as well as any amounts drawn by the IMF from a letter of credit made available by the United States as part of its financial subscription to the IMF. The IMF promotes international monetary cooperation and a stable payment system to facilitate growth in the world economy. Its primary activities are surveillance of member economies, financial assistance as appropriate and technical assistance.

Only a portion of the U.S. financial subscriptions to the IMF is made in the form of reserve assets; the remainder is provided in the form of a letter of credit from the United States to the IMF. The balance available under the letter of credit totaled \$41.3 billion and \$43.0 billion as of September 30, 2012, and 2011, respectively. The U.S. reserve position in the IMF has a U.S. dollar equivalent of \$23.5 billion and \$22.7 billion as of September 30, 2012, and 2011, respectively.

The SDR is an international reserves asset created by the IMF to supplement the existing reserve assets of its members. These interest-bearing assets can be obtained by IMF allocations, transactions with IMF member countries, or in the form of interest earnings on SDR holdings and reserve position in the IMF. U.S. SDR holdings are an interest-bearing asset of Treasury's Exchange Stabilization Fund (ESF). The total amount of SDR holdings of the United States was the equivalent of \$55.2 billion and \$55.9 billion as of September 30, 2012, and 2011, respectively.

The IMF allocates SDRs to its members in proportion to each member's quota in the IMF. The SDR Act, enacted in 1968, authorized the Secretary of the Treasury to issue SDR Certificates (SDRCs) to the Federal Reserve in exchange for dollars. The amount of SDRCs outstanding cannot exceed the dollar value of SDR holdings. The Secretary of the Treasury determines when Treasury will issue or redeem SDRCs. SDRCs outstanding totaled \$5.2 billion as of September 30, 2012, and 2011, and are included in Note 19—Other Liabilities.

As of September 30, 2012, and 2011, other liabilities included \$54.5 billion and \$55.1 billion of interest-bearing liability to the IMF for SDR allocations. The SDR allocation item represents the cumulative total of SDRs distributed by the IMF to the United States in allocations that occurred in 1970, 1971, 1972, 1979, 1980, 1981, and 2009. The United States has received no SDR allocations since 2009.

Gold is valued at the statutory price of \$42.2222 per fine troy ounce. The number of fine troy ounces of gold was 261,498,927 and 261,498,900 as of September 30, 2012, and 2011, respectively. The market value of gold on the London Fixing was \$1,776 and \$1,620 per fine troy ounce as of September 30, 2012, and 2011, respectively. In addition, silver is valued at the statutory price of \$1.2929 per fine troy ounce. The number of fine troy ounces of silver was 16,000,000 as of September 30, 2012, and 2011. The market value of silver on the London Fixing was \$34.65 and \$30.45 per fine troy ounce as of September 30, 2012, and 2011, respectively. Gold totaling \$11.0 billion as of September 30, 2012, and 2011, was pledged as collateral for gold certificates issued and authorized to the FRBs by the Secretary of the Treasury. Gold certificates were valued at \$11.0 billion as of September 30, 2012, and 2011, which are included in Note 19—Other Liabilities. Treasury may redeem the gold certificates at any time. Foreign currency is translated into U.S. dollars at the exchange rate at fiscal yearend. The foreign currency is maintained by the ESF and various U.S. Federal agencies and foreign banks.

### Note 3. Accounts and Taxes Receivable, Net

#### Accounts and Taxes Receivable as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
Accounts receivable:		
Gross accounts receivable .....	92.6	89.2
Allowance for uncollectible accounts.....	<u>(23.1)</u>	<u>(20.7)</u>
Accounts receivable, net .....	69.5	68.5
Taxes receivable:		
Gross taxes receivable .....	156.8	151.5
Allowance for doubtful accounts.....	<u>(115.1)</u>	<u>(113.7)</u>
Taxes receivable, net .....	41.7	37.8
Total accounts and taxes receivable, net .....	<u>111.2</u>	<u>106.3</u>

Accounts receivable includes related interest receivable of \$7.5 billion and \$6.6 billion as of September 30, 2012, and 2011, respectively.

Treasury comprises approximately 37.3 percent of the Government's reported accounts and taxes receivable, net, as of September 30, 2012. Refer to the individual financial statements of Treasury, the Social Security Administration, the Department of Defense, the Department of Health and Human Services, the Department of Agriculture, the Department of Energy, the Department of Homeland Security, the Department of the Interior, the Pension Benefit Guaranty Corporation, and the Department of Labor for significant detailed information on gross accounts and taxes receivable and the related allowance for doubtful accounts. These agencies comprise 89.7 percent of the Government's accounts and taxes receivable, net, of \$111.2 billion as of September 30, 2012.



## Note 4. Loans Receivable, Mortgage-Backed Securities and Loan Guarantee Liabilities, Net

### Direct Loan, Mortgage-Backed Securities and Defaulted Guaranteed Loan Programs as of September 30, 2012, and 2011

	Face Value of Loans Outstanding		Long-term Cost of (Income from) Direct Loans and Defaulted Guaranteed Loans Outstanding		Loans Receivable, Mortgage-Backed Securities, Net		Subsidy Expense (Income) for the Fiscal Year	
	2012	2011	2012	2011	2012	2011	2012	2011
(In billions of dollars)								
Federal Direct Student Loans - Education .....	495.5	356.1	(31.6)	(25.3)	527.1	381.5	(10.7)	(28.6)
Federal Family Education Loans - Education .....	147.0	147.3	0.9	(0.8)	146.1	148.0	(2.8)	(4.9)
Electric Loans - USDA .....	43.3	42.2	1.4	2.1	41.9	40.2	-	(0.2)
Rural Housing Services - USDA .....	31.5	30.7	6.8	7.1	24.7	23.6	0.3	0.5
Housing and Urban Development Loans .....	15.5	13.9	1.9	1.3	13.6	12.6	(0.9)	0.2
International Monetary Fund Program - Treasury .....	13.9	8.2	0.3	0.1	13.6	8.1	-	0.1
State and Local Housing Finance Agency Initiative - Treasury .....	13.7	15.1	1.1	0.8	12.6	14.3	0.5	-
Water and Environmental Loans - USDA .....	12.1	11.9	0.5	0.7	11.6	11.1	(0.1)	-
Export-Import Bank Loans .....	13.9	9.9	2.8	2.8	11.1	7.0	(0.6)	(0.4)
Farm Loans - USDA .....	8.8	8.6	0.4	0.4	8.4	8.3	-	0.2
Disaster Loan Programs - SBA .....	7.2	7.5	1.4	1.5	5.8	6.0	-	0.2
Telecommunications Loans - USDA....	4.6	4.5	(0.1)	-	4.7	4.5	-	-
U. S. Agency for International Development Loans .....	4.1	4.7	1.3	1.3	2.8	3.4	-	-
Food Aid - USDA .....	4.5	5.2	2.0	2.5	2.5	2.7	-	-
GSE Mortgage-Backed Securities Purchase Program - Treasury .....	-	70.6	-	(1.8)	-	72.4	(0.7)	1.8
All other programs .....	44.0	40.1	10.9	11.7	33.1	28.4	1.3	2.1
Total direct loans, Mortgage- Backed Securities and defaulted guaranteed loans .....	859.6	776.5	-	4.4	859.6	772.1	(13.7)	(29.0)

**Loan Guarantees as of September 30, 2012, and 2011**

	Principal Amount of Loans under Guarantee		Principal Amount Guaranteed by the United States		Loan Guarantee Liabilities		Subsidy Expense (Income) for the Fiscal Year	
	2012	2011	2012	2011	2012	2011	2012	2011
(In billions of dollars)								
Federal Housing Administration Loans - HUD.....	1,253.4	1,167.1	1,170.2	1,096.8	55.0	36.1	(6.0)	(7.2)
Federal Family Education Loans - Education.....	290.7	327.6	284.6	320.7	1.0	10.0	(11.6)	(11.2)
Export-Import Bank Guarantees .....	76.4	70.7	76.4	70.7	1.8	1.2	(0.4)	(0.2)
Veterans Housing Benefit Programs - VA .....	286.6	247.7	76.1	66.2	5.6	5.1	0.6	0.6
Small Business Loans - SBA .....	87.4	82.2	74.4	70.0	3.7	4.7	0.3	2.4
Rural Housing Services - USDA .....	77.0	63.3	69.3	56.9	3.2	2.5	0.7	0.3
Israeli Loan Guarantee Program - AID ...	11.3	11.6	11.3	11.6	1.3	1.3	(0.1)	-
Export Credit Guaranteed Programs - USDA .....	6.2	6.1	6.1	6.0	0.2	0.1	-	0.1
Overseas Private Investment Corporation Credit Program .....	5.4	4.9	5.4	4.9	0.2	0.2	-	-
Business and Industry Loans - USDA .....	7.1	7.0	5.3	5.3	0.9	0.8	0.2	0.4
Federal Ship Financing Fund (Title XI) - DOT.....	2.0	1.8	2.0	1.8	0.2	0.2	-	-
All Other Guaranteed Loan Programs.....	26.3	22.6	23.7	20.8	1.5	0.8	0.6	(0.1)
Total loan guarantees .....	<u>2,129.8</u>	<u>2,012.6</u>	<u>1,804.8</u>	<u>1,731.7</u>	<u>74.6</u>	<u>63.0</u>	<u>(15.7)</u>	<u>(14.9)</u>

The Government has two different types of loans and loan guarantees. One major type of loan is direct loans such as the Department of Education's (Education) Federal Direct Student Loans. The second type is loan guarantee programs, such as the Department of Housing and Urban Development's (HUD's) Federal Housing Administration Loans program.

Direct loans and loan guarantee programs are used to promote the Nation's welfare by making financing available to segments of the population not served adequately by non-Federal institutions, or otherwise providing for certain activities or investments. For those unable to afford credit at the market rate, Federal credit programs provide subsidies in the form of direct loans offered at an interest rate lower than the market rate. For those to whom non-Federal financial institutions are reluctant to grant credit because of the high risk involved, Federal credit programs guarantee the payment of these non-Federal loans and absorb the cost of defaults.

The amount of the long-term cost of post-1991 direct loans and loan guarantees outstanding equals the subsidy cost allowance for direct loans and the liability for loan guarantees as of September 30. The amount of the long-term cost of pre-1992 direct loans and loan guarantees equals the allowance for uncollectible amounts (or present value allowance) for direct loans and the liability for loan guarantees. The long-term cost is based on all direct loans and guaranteed loans disbursed in this fiscal year and previous years that are outstanding as of September 30. It includes the subsidy cost of these loans and guarantees estimated as of the time of loan disbursement and subsequent adjustments such as modifications, reestimates, amortizations, and writeoffs.

Net loans receivable includes related interest and foreclosed property. Foreclosed property is property that is transferred from borrowers to a Federal credit program, through foreclosure or other means, in partial or full settlement of post-1991 direct loans or as a compensation for losses that the Government sustained under post-1991 loan guarantees. Please refer to the individual financial statements of the Department of Veterans Affairs (VA) and HUD for significant detailed information regarding foreclosed property.

The total subsidy expense/(income) is the cost of direct loans and loan guarantees recognized during the fiscal year. It consists of the subsidy expense/(income) incurred for direct and guaranteed loans disbursed during the fiscal year, for modifications made during the fiscal year of loans and guarantees outstanding, and for upward or downward re-estimates as of the end of the fiscal year of the cost of loans and guarantees outstanding. This expense/(income) is included in the Statements of Net Cost.

## Loan Programs

The majority of the loan programs are provided by Education, HUD, United States Department of Agriculture (USDA), Treasury, Small Business Administration (SBA), VA, and Export-Import Bank. For significant detailed information regarding the direct and guaranteed loan programs listed in the tables above, please refer to the individual financial statements of the agencies.

Education has two major loan programs, authorized by Title IV of the Higher Education Act of 1965 (HEA). The first program, is the William D. Ford Federal Direct Student Loan Program, (referred to as the Direct Loan Program) that was established in fiscal year 1994. The Direct Loan Program offers four types of educational loans: Stafford, Unsubsidized Stafford, PLUS for parents and graduate or professional students, and consolidation loans. With this program, the Government makes loans directly to students and parents through participating institutions of higher education. Direct loans are originated and serviced through contracts with private vendors. Education disbursed approximately \$142.0 billion in Direct Loans to eligible borrowers in fiscal year 2012 and approximately \$133.0 billion in fiscal year 2011. The second program is the Federal Family Education Loan (FFEL) Program. This program was established in fiscal year 1965, and is a guaranteed loan program. Like the William D. Ford Federal Direct Student Loan Program, it offers four types of loans: Stafford, Unsubsidized Stafford, PLUS for parents and graduate or professional students, and consolidation loans. The Student Aid and Fiscal Responsibility Act (SAFRA), which was enacted as part of the Health Care Education and Reconciliation Act of 2010 (Public Law 111-152), eliminated the authority to guarantee new FFEL after June 30, 2010.

The Housing and Economic Recovery Act of 2008 (HERA) authorized Treasury to purchase GSE MBS consisting of mortgage pass-through securities issued by Fannie Mae and Freddie Mac. Treasury, using private sector asset managers, purchased such securities on the open market. By purchasing these credit-guaranteed securities, Treasury sought to broaden access to mortgage funding for current and prospective homeowners and to promote stability in the mortgage market. The authority granted by Congress to purchase MBS expired on December 31, 2009, at which point the purchase of new securities ended.

Treasury originally planned to hold the MBS securities to maturity. However, in fiscal year 2011, Treasury decided its goals had been achieved and began an orderly sale of its MBS portfolio. Sales were completed during fiscal year 2012.

As of September 30, 2011, the \$72.4 billion MBS net credit program receivable included a negative subsidy allowance of \$1.8 billion. The subsidy allowance was negative in that the Treasury expected to generate earnings in excess of costs on its portfolio. Since Treasury originally planned to hold all MBS securities to maturity, the sale of the GSE MBS portfolio was not considered in the formulation estimate for the GSE MBS program. Accordingly, Treasury recorded a modification in fiscal year 2011, resulting in an upward reestimate or increase in the cost of the program by \$9.7 billion. Subsequently, at September 30, 2011, Treasury performed a financial statement reestimate of the program's cost that resulted in a downward reestimate, or a decrease in the cost of the program by \$7.9 billion. The decrease in program costs was the result of higher than projected sales proceeds when compared to projected sales proceeds in the modification. The effects of the modification and financial statement reestimate, when combined with other reconciling items, resulted in the \$1.8 billion negative subsidy allowance at September 30, 2011. As of September 30, 2012, Treasury performed a financial statement reestimate of the program's cost that identified excess sales proceeds of \$705.0 million for fiscal year 2012. A closing reestimate will be performed in early fiscal year 2013.

In 2009, Congress passed the *Supplemental Appropriations Act of 2009* which authorized an increase in the U.S. quota in the IMF, as well as an increase in U.S. participation in the New Arrangements to Borrow, one of the IMF's supplemental borrowing arrangements. For the first time, Congress subjected both program increases to FCRA. Under FCRA, both program increases are treated as direct loans to the IMF.

HUD's Federal Housing Administration (FHA) provides mortgage insurance to encourage lenders to make credit available to expand home ownership. FHA serves many borrowers that the conventional market does not serve adequately. This includes first-time homebuyers, minorities, low-income, and other underserved households to realize the benefit of home ownership. Borrowers obtain an FHA insured mortgage and pay an upfront premium and an annual premium to FHA. The proceeds from those premiums are used to fund FHA program costs, including claims on defaulted mortgages and holding costs, property management fees, property sales, and other associated costs. The possibility of a sizable volume of delinquencies remains a significant risk for the housing market and for FHA in the near term. The number of FHA mortgages has risen dramatically. HUD decided to raise the annual premium and lower the upfront premium to aid in returning the Mutual Mortgage Insurance Fund to congressionally mandated levels of capital reserves without disruption to the marketplace.

USDA offers direct and guaranteed loans through credit programs in the Farm and Foreign Agricultural Services (FFAS) mission area through the Farm Service Agency (FSA), and the Commodity Credit Corporation (CCC), and in the Rural Development (RD) mission area.

The FFAS delivers commodity, credit, conservation, disaster and emergency assistance programs that help strengthen and stabilize the agricultural economy. The FSA offers direct and guaranteed loans to farmers who are temporarily unable to obtain private, commercial credit. Through this supervised credit offered by FSA, the goal is to graduate its borrowers to commercial credit. The CCC offers both credit guarantee and direct credit programs for buyers of U.S. exports, suppliers, and sovereign countries in need of food assistance. The RD provides affordable housing and essential community facilities to rural communities through its rural housing loan and grant programs. The Rural Utilities Program helps to improve the quality of life in rural America through a variety of loan programs for electric energy, telecommunications, and water and environmental projects.

The Export-Import Bank aids in financing and promoting U.S. exports. The average repayment term for these loans is approximately 7 years.

The Small Business Administration's (SBA's) Disaster Assistance Loan Program makes direct loans to disaster victims primarily for homes and personal property.

## Note 5. Troubled Asset Relief Program (TARP) — Direct Loans and Equity Investments, Net

The TARP was authorized by the EESA. This Act gave the Secretary of the Treasury broad flexible authority to establish the TARP to purchase and guarantee mortgages, mortgage related securities, and other troubled assets from financial institutions. This permitted the Secretary of the Treasury to inject capital into, and receive equity interests in, banks and other financial institutions. Treasury established several programs under the TARP designed to help stabilize the financial system, restore the flow of credit to consumers and businesses, and help prevent avoidable foreclosures. Under the TARP programs, Treasury made direct loans, equity investments, and entered into other credit programs. This authority to make new commitments to purchase or guarantee troubled assets expired on October 3, 2010.

The following table lists the TARP programs and types:

Program	Program Type
American International Group, Inc. Investment Program	Equity Investment
Public-Private Investment Program	Equity Investment and Direct Loan
Automotive Industry Financing Program	Equity Investment and Direct Loan
Capital Purchase Program	Equity Investments/Subordinated Debentures
Other Programs	Direct Loan, Subordinated Debentures and Equity Investments
Housing Programs under TARP*	Expenditure and Loss Sharing

\*Housing Programs under TARP are not designed to recoup money spent on loan modifications or payments on the loss sharing agreement. As such, these programs do not include direct loans, equity investments, or asset guarantees.

The table below is a summary of TARP—Direct Loans and Equity Investments, Net.

### Troubled Asset Relief Program Direct Loans and Equity Investments as of September 30, 2012, and 2011

(In billions of dollars)	Direct Loans and Equity Investments		Subsidy Cost Allowance		Net Direct Loans and Equity Investments		Subsidy Expense (Income) for the Fiscal Year	
	2012	2011	2012	2011	2012	2011	2012	2011
Automotive Industry Financing Program ....	37.2	37.3	(19.7)	(19.4)	17.5	17.9	0.2	9.7
Public-Private Investment Program .....	9.8	15.9	1.0	2.4	10.8	18.3	0.2	(1.9)
Capital Purchase Program.....	8.7	17.3	(2.9)	(4.9)	5.8	12.4	(1.9)	(1.8)
American International Group, Inc. Investment Program .....	6.7	51.1	(1.7)	(20.7)	5.0	30.4	(9.2)	1.6
All other .....	0.7	0.8	0.4	0.3	1.1	1.1	(0.1)	(0.4)
Total Troubled Asset Relief Program .....	63.1	122.4	(22.9)	(42.3)	40.2	80.1	(10.8)	7.2

### Automotive Industry Financing Program (AIFP)

The Automotive Industry Financing Program was designed to help prevent a significant disruption of the American automotive industry, which could have had a negative effect on the economy of the United States. The various activities undertaken by Treasury in the automotive industry include:

**General Motors (GM)**—In fiscal year 2009, Treasury provided \$49.5 billion to Old GM through various loan agreements including the initial loan for general and working capital purposes and the final loan for debtor in possession (DIP) financing while Old GM was in bankruptcy. Treasury assigned its rights in these loans, with the exception of \$1.0 billion which remained in Old GM, to a newly created entity New GM, which New GM used to credit bid for substantially all of the assets in Old GM. New GM and Treasury extinguished substantially all but \$7.1 billion of these initial financing arrangements, and Treasury received \$2.1 billion in 9.0 percent cumulative perpetual preferred stock and 60.8 percent of the common equity interest in New GM in fiscal year 2009. New GM also assumed \$7.1 billion of the original DIP loan, which it fully repaid to Treasury in fiscal year 2010. During fiscal year 2011, pursuant to a letter agreement between Treasury and New GM, New GM repurchased its preferred stock for 102.0 percent of its liquidation amount, or \$2.1 billion. Also in fiscal year 2011, as a result of the New GM initial public offering, Treasury sold approximately 412 million shares of its GM common stock for approximately \$13.5 billion. As of September 30, 2012, and 2011, Treasury held 500 million shares of the common stock of New GM's common stock shares outstanding (or approximately 32.0 percent). The fair values of Treasury's holdings of New GM common stock as of September 30, 2012, and 2011, totaled approximately \$11.4 billion and 10.1 billion, respectively. Treasury retains the right to recover additional proceeds relating to the liquidation of Old GM. However, Treasury does not expect these recoveries to be significant. Please see Note 28—Subsequent Events for additional information.

**Ally Financial Inc. (formerly known as GMAC Inc.)**—Between December 2008 and 2009, Treasury invested a total of \$16.3 billion in GMAC Inc. to help support its ability to originate new loans to GM and Chrysler dealers and consumers, and to help address GMAC's capital needs. GMAC changed its corporate name to Ally Financial, Inc. (Ally) in May 2010. Treasury held 981,971 shares of Ally's outstanding common stock (or 73.8 percent) as of September 30, 2012 and 2011. As of September 30, 2012, and 2011, Treasury also held 119 million shares of Ally Series F-2 Mandatorily Convertible Preferred Securities, with a \$50 per share liquidation preference, with a stated dividend rate of 9.0 percent, and convertible into at least 513,000 shares of Ally common stock at Ally's option,

which is subject to an approval of the FRB and consent by Treasury or pursuant to an order by the FRB compelling such conversion. The Series F-2 security is also convertible at the option of Treasury upon certain specified corporate events. Absent any optional conversion, any F-2 remaining preferred shares will automatically convert to Ally common stock after 7 years from the issuance date. Treasury would own 81.0 percent ownership of Ally common stock when combined with the Ally common stock currently owned and conversion of the Series F-2 preferred stock into common stock.

Treasury held 2.7 million shares of 8.0 percent cumulative Trust Preferred Securities (TRuPS) with a \$1,000 per share liquidation preference prior to fiscal year 2011. In March 2011, Treasury sold its TRuPs for \$2.7 billion.

**Chrysler Holding LLC (Chrysler)**—In fiscal year 2009, Treasury provided \$5.9 billion in loans to Chrysler Holding LLC (Old Chrysler). In April 2009, Old Chrysler filed for Chapter 11 bankruptcy, and in June 2009, substantially all of the Old Chrysler assets were sold to a newly-created entity (New Chrysler). In June 2009, New Chrysler assumed \$0.5 billion of the loans to Old Chrysler, and Treasury committed to lend New Chrysler \$6.6 billion (of which only \$4.6 billion was funded), and received other consideration including 9.85 percent equity in New Chrysler and \$0.4 billion in additional notes. In May 2011, New Chrysler repaid the \$5.1 billion in loans outstanding, the \$0.4 billion additional notes, and the associated interest. In July 2011, Fiat SpA paid Treasury \$0.6 billion for all of its remaining equity interest and rights relating to New Chrysler. As of September 2012 and 2011, Treasury had no remaining interest in New Chrysler. As of these dates, Treasury continued to hold a right to receive proceeds from a bankruptcy liquidation trust, but no significant cashflows are expected.

### **Public Private Investment Program (PPIP)**

The PPIP is part of Treasury's efforts to help restart the markets and provide liquidity for legacy assets. Under this program, Treasury made equity investments and loans to nine investment vehicles (referred to as Public Private Investment Funds or "PPIFs") established by private investment managers. The PPIFs may invest in commercial mortgage-backed securities and non-agency residential MBS as well as in temporary securities, including bank deposits, U.S. Treasury securities and certain money market mutual funds. During fiscal year 2012, Treasury disbursed \$0.2 billion as equity investment and \$0.8 billion as loans to these PPIFs as compared to \$1.1 billion as equity investment and \$2.3 billion as loans in fiscal year 2011. On September 30, 2012, and 2011, Treasury had equity investments in PPIFs outstanding of \$4.1 billion and \$5.5 billion, and loans outstanding of \$5.7 billion and \$10.4 billion, for a total of \$9.8 billion and \$15.9 billion, respectively. In addition, as of September 2012, and 2011, Treasury had legal commitments to disburse up to \$3.1 billion and \$4.3 billion, respectively, for additional investments and loans in PPIFs.

### **Capital Purchase Program**

In October 2008, Treasury began implementation of the Capital Purchase Program (CPP), designed to help stabilize the financial system by assisting in building the capital base of certain viable U.S. financial institutions to increase the capacity of those institutions to lend to businesses and consumers and support the economy. Under this program, Treasury purchased senior perpetual preferred stock with a stated dividend rate of 5.0 percent through year five, increasing to 9.0 percent in subsequent years, from qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies (Qualified Financial Institution). The dividends are cumulative for bank holding companies and subsidiaries of bank holding companies and non-cumulative for others and payable when and if declared by the institution's board of directors. In addition to the senior preferred stock, Treasury received warrants from public QFIs to purchase shares of common stock. QFIs that are Sub-chapter S corporations issued subordinated debentures; these subordinated debentures have a maturity of 30 years and interest rates of 7.7 percent for the first 5 years and 13.8 percent for the remaining years, and may repay Treasury subject to regulatory approval at any time. For fiscal years 2012 and 2011, repayments and sales totaled \$8.2 billion and \$30.2 billion, respectively.

## American International Group, Inc. Investment Program (AIG)

Treasury provided assistance to help AIG in order to prevent its disorderly failure as well as to prevent broader disruption to the financial markets. In fiscal year 2009, Treasury made an investment in AIG (which, after being restructured in the same fiscal year) consisted of \$41.6 billion of AIG's non-cumulative 10.0 percent Series E preferred stock. Additionally, Treasury made available to AIG a \$29.8 billion capital facility (non-cumulative 10.0 percent Series F preferred stock) under which AIG drew \$27.8 billion to assist in its operational restructuring. In January 2011, AIG, Treasury, and Federal Reserve Bank of New York (FRBNY) restructured the U.S. Government's investments in AIG. The restructuring converted the \$41.6 billion Series E preferred stock and \$27.8 billion investment in Series F equity capital facility into \$20.3 billion of interest in AIG Special Purpose Vehicles (SPVs), and 1.1 billion shares of AIG common stock. The remaining \$2.0 billion of undrawn Series F capital facility was converted to a new AIG equity capital facility, which subsequently reduced to zero later in fiscal year 2011. As described in Note 6—Non-TARP Investments in American International Group, Inc., as part of the restructuring, Treasury also received, on behalf of the General Fund, 563 million shares of AIG's common stock in exchange for its beneficial interest in a Trust established by the FRBNY. Additionally, the credit facility between FRBNY and AIG was terminated. Upon completion of the restructuring, Treasury under TARP and the General Fund received a combined total of 1.7 billion shares (or 92.1 percent ownership) of AIG common stock.

Since the January 2011 restructuring, shares of AIG common stock have been sold. In fiscal years 2012 and 2011, Treasury sold 806 million and 132 million shares of AIG's common stock under TARP for \$25.2 billion and \$3.8 billion, respectively. As of September 30, 2012, Treasury held 154 million shares of AIG's common stock under TARP, with a fair value of approximately \$5.1 billion, representing 10.5 percent of the AIG shares outstanding. As of September 30, 2011, Treasury held 960 million shares of AIG's common stock under TARP, with a fair value of approximately \$21.1 billion representing 50.8 percent of AIG shares outstanding. Refer to Note 6—Non-TARP Investments in American International Group, Inc., for the detail discussions on Non-TARP investments in AIG.

As of September 30, 2011, Treasury also owned preferred interests in an AIG SPV with an outstanding balance of \$9.3 billion. In fiscal year 2012, the preferred interests in the AIG SPV were fully repaid. Please see Note 28—Subsequent Events for additional information.

## Other Programs

Treasury implemented other programs under TARP to help unlock the flow of credit to consumers and small businesses. The following four programs were established to help accomplish this: Term Asset-Backed Securities Loan Facility (TALF), SBA 7(a) Securities Purchase Program, Community Development Capital Initiative (CDCI), and the Targeted Investment Program (TIP).

TALF, was created by the Federal Reserve FRBNY to provide low cost funding to investors in certain classes of Asset-Backed Securities (ABS). Treasury participated in the program by providing liquidity and credit protection to the FRBNY. Under the TALF, the FRBNY originated loans on a non-recourse basis to holders of certain AAA rated ABS. Interest rates charged on the TALF loans depend on the weighted-average maturity of the pledged collateral, the collateral type and whether the collateral pays fixed or variable interest. As part of the program, the FRBNY created the TALF, LLC, an SPV that agreed to purchase from the FRBNY any collateral it has seized because of borrower default. In the event there are insufficient funds to purchase the collateral, Treasury committed to invest up to \$20.0 billion in non-recourse subordinate notes issued by the TALF, LLC. In fiscal year 2010, the Treasury commitment was reduced to \$4.3 billion and further reduced in fiscal year 2012 to \$1.4 billion. As of September 30, 2012 and 2011, approximately \$1.5 billion and \$11.3 billion of loans due to FRBNY remained outstanding, respectively.

The SBA 7(a) Securities Purchase Program was created to provide additional liquidity to the SBA 7(a) market so that banks are able to make more small business loans. Under this program, Treasury purchased 7(a) Securities collateralized with 7(a) loans that were guaranteed by the full faith and credit of the U.S. Government. In May 2011, Treasury began selling its securities to bond market investors; sales were completed and the programs closed in January 2012. As of September 30, 2012, Treasury held no investment in SBA 7(a) securities.

The CDCI Initiative was created to provide additional low-cost capital to small banks to encourage more lending to small businesses. Under the terms of the initiatives, Treasury purchased senior preferred stock (or subordinated debt) from eligible CDFI financial institutions with an initial dividend rate of 2.0 percent, increasing up to a maximum of 9.0 percent after 8 years. CDFIs participating in the CPP, subject to certain criteria, were eligible to exchange, through September 30, 2010, their current CPP preferred shares (subordinated debt) for CDCI preferred shares (subordinated debt).



TIP was designed to prevent a loss of confidence in financial institutions that could result in significant market disruptions, threatening the financial strength of similarly situated financial institutions, impairing broader financial markets, and undermining the overall economy. In fiscal year 2009, Treasury invested \$20.0 billion in each of Bank of America and Citigroup under TIP. In December 2009, both institutions repaid the invested amounts along with dividends through the date of repayment. In fiscal year 2010, Treasury received a total of \$1.1 billion in dividends on the Bank of America and Citigroup investments and proceeds of \$1.2 billion from the sale of Bank of America warrants. In fiscal year 2011, Treasury sold its warrants from Citigroup under TIP for \$0.2 billion, and closed the program.

### **Housing Programs under TARP**

Housing Programs under TARP are not designed to recoup money spent on loan modifications or payments on the loss sharing agreement. As such, these programs do not include direct loans, equity investments, or asset guarantees.

The following housing programs under TARP are designed to help prevent avoidable foreclosures. These programs provide incentives for mortgage modifications and other types of assistance in order to enable homeowners who are experiencing hardships to remain in their homes or relocate to more sustainable living situations. These programs fall into three initiatives:

- Making Home Affordable Program;
- Housing Finance Agency Hardest-Hit Fund, and
- Federal Housing Administration Refinance Program.

As of September 30, 2012, and 2011, Treasury has committed up to \$45.6 billion for these programs. Payments made under the housing programs under TARP for fiscal years 2012 and 2011, amounted to \$3.1 billion and \$1.9 billion, respectively. As of September 30, 2012, Treasury had \$40.1 billion in total commitments outstanding for future payments under the housing programs.

For more details on the TARP, please see the Treasury's Annual Financial Report.

## Note 6. Non-TARP Investments in American International Group, Inc.

Under the initial terms of a capital facility agreement between the FRBNY and AIG, a 77.9 percent equity interest in AIG (in the form of Series C Convertible Participating Serial Preferred Stock convertible into approximately 77.9 percent of the issued and outstanding shares of AIG common stock) was issued to a trust (Trust) established by the FRBNY. Subsequent to the initial agreement, a reverse stock split of AIG's common stock increased this equity interest to 79.8 percent. The General Fund of the U.S. Government was the sole beneficiary of the Trust. In connection with the establishment of the Trust, Treasury, as custodian of the General Fund, recorded a non-entity asset of \$23.5 billion as of September 30, 2009, along with a corresponding entry to custodial revenue for the same amount, to reflect the value of the General Fund's beneficiary interest holding in the Trust. As of September 30, 2010, the value of the Trust had declined by \$2.7 billion, reducing the carrying value of this non-entity asset to \$20.8 billion.

On September 30, 2010, an AIG Recapitalization Agreement was established for the purpose of restructuring the holdings in AIG. This restructuring was executed on January 14, 2011, converting the Trust's AIG preferred stock into 563 million shares of AIG common stock, and the Trust was dissolved (see Note 5—Troubled Asset Relief Program (TARP)—Direct Loans and Equity Investments, Net for a discussion of the TARP-related transactions that occurred in connection with the January 14, 2011, restructuring).

During fiscal year 2011, 68 million shares of AIG common stock held by the General Fund were sold in the open market. The sale of the AIG common stock resulted in total gross cash proceeds of \$2.0 billion to the General Fund for the fiscal year ended September 30, 2011.

During fiscal year 2012, Treasury sold 415 million shares of AIG common stock held by the General Fund. The sale of the AIG common stock resulted in total gross proceeds of \$13.0 billion to the General Fund for the fiscal year ended September 30, 2012.

After taking into consideration the sale of AIG common stock, the General Fund owned 80 million and 495 million shares of AIG outstanding common stock as of September 30, 2012, and 2011, respectively. The carrying value of the non-TARP investment in AIG was \$2.6 billion and \$10.9 billion as of September 30, 2012, and 2011, respectively, which represented the fair value as of that date of the remaining AIG common stock held by the General Fund. The fair value of the non-entity assets recorded as of September 30, 2012, and 2011, was based on the market value of AIG's common stock which is actively traded on the New York Stock Exchange. The September 30, 2012, carrying value of AIG investments held on behalf of the General Fund declined by \$8.3 billion from the end of fiscal year 2011 due to sales of \$13.0 billion, partially offset by a fair value gain of \$4.7 billion during fiscal year 2012. The September 30, 2011, carrying value declined by \$9.9 billion from the end of fiscal year 2010, due to sales of \$2.0 billion and a fair value loss of \$7.9 billion during fiscal year 2011.

The fair market value of the Non-TARP Investments in AIG as of September 30, 2012 and September 30, 2011, are included in the equity securities common stock line item in the available-for-sale category of Note 9—Debt and Equity Securities. Please see Note 28—Subsequent Events for additional information.

## Note 7. Inventories and Related Property, Net

### Inventories and Related Property as of September 30, 2012, and 2011

(In billions of dollars)	All			All		
	Defense	Others	Total	Defense	Others	Total
	2012			2011		
Inventory purchased for resale .....	61.6	0.6	62.2	65.1	0.6	65.7
Inventory and operating material and supplies held for repair .....	52.8	1.4	54.2	48.3	0.6	48.9
Inventory—excess, obsolete, and unserviceable .....	6.8	0.1	6.9	7.8	-	7.8
Operating materials and supplies held for use.....	134.6	3.2	137.8	131.4	2.7	134.1
Operating materials and supplies held in reserve for future use .....	-	0.1	0.1	-	0.2	0.2
Operating materials and supplies—excess, obsolete, and unserviceable .....	1.9	0.1	2.0	2.2	0.1	2.3
Stockpile materials .....	-	49.9	49.9	-	48.6	48.6
Stockpile materials held for sale .....	0.5	0.1	0.6	0.5	0.2	0.7
Other related property .....	1.4	0.8	2.2	1.7	0.9	2.6
Allowance for loss .....	(16.3)	(0.6)	(16.9)	(14.5)	(0.3)	(14.8)
Total inventories and related property, net .....	<u>243.3</u>	<u>55.7</u>	<u>299.0</u>	<u>242.5</u>	<u>53.6</u>	<u>296.1</u>

Inventory purchased for resale is the cost or value of tangible personal property purchased by an agency for resale. As of September 30, 2012, DOD values approximately 84 percent of its resale inventory using the moving average cost (MAC) method. An additional 12 percent (fuel inventory) is reported using the first-in-first-out method. DOD reports the remaining 4 percent of resale inventories at an approximation of historical cost using LAC adjusted for holding gains and losses. The LAC method is used because DOD's legacy inventory systems do not maintain historical cost data.

Please refer to the individual financial statements of DOD for significant detailed information regarding its inventories.

Inventory and operating materials and supplies held for repair are damaged inventory that require repair to make them suitable for sale (inventory) or is more economical to repair than to dispose of (operating materials and supplies).

Inventory—excess, obsolete, and unserviceable consists of:

- Excess inventory that exceeds the demand expected in the normal course of operations and which does not meet management's criteria to be held in reserve for future sale.
- Obsolete inventory that is no longer needed due to changes in technology, laws, customs, or operations.
- Unserviceable inventory that is damaged beyond economic repair.

Excess, obsolete, and unserviceable inventory is reported at net realizable value.

Operating materials and supplies held for use are tangible personal property to be consumed in normal operations.

Operating materials and supplies held in reserve for future use are materials retained because they are not readily available in the market or because they will not be used in the normal course of operations, but there is more than a remote chance they will eventually be needed. DOD, which accounts for most of the reported operating materials and supplies held for use, uses LAC, MAC, and Standard Price and expends a significant amount when purchased instead of when consumed.

Operating materials and supplies—excess, obsolete, and unserviceable consists of:

- Excess operating materials and supplies are materials that exceed the demand expected in the normal course of operations, and do not meet management's criteria to be held in reserve for future use.
- Obsolete operating materials and supplies are materials no longer needed due to changes in technology, laws, customs, or operations.
- Unserviceable operating materials and supplies are materials damaged beyond economic repair.

DOD, which accounts for most of the reported excess, obsolete, and unserviceable operating materials and supplies, revalues it to a net realizable value of zero through the allowance account.

Please refer to the individual financial statements of DOD for significant detailed information regarding operating materials and supplies.

Stockpile materials include strategic and critical materials held in reserve for use in national defense, conservation, or national emergencies due to statutory requirements; for example, nuclear materials and oil, and stockpile materials that are authorized to be sold. The majority of the amount reported by DOD is stockpile materials held for sale, and the amount reported by others is stockpile materials held in reserve, with the majority of it being reported by the Department of Energy (DOE). Please refer to their individual financial statements for more information on stockpile materials.

Other related property consists of the following:

- Commodities include items of commerce or trade that have an exchange value used to stabilize or support market prices. Please refer to the financial statements of the USDA for detailed information regarding commodities.
- Seized monetary instruments are comprised only of monetary instruments that are awaiting judgment to determine ownership. The related liability is included in other liabilities. Other property seized by the Government, such as real property and tangible personal property, is not considered a Government asset. It is accounted for in agency property-management records until the property is forfeited, returned, or otherwise liquidated. Please refer to the individual financial statements of the Department of Justice (DOJ), Treasury, and the Department of Homeland Security (DHS) for significant detailed information regarding seized property.
- Forfeited property is comprised of monetary instruments, intangible property, real property, and tangible personal property acquired through forfeiture proceedings; property acquired by the Government to satisfy a tax liability; and unclaimed and abandoned merchandise. Please refer to the individual financial statements of DOJ, Treasury, and DHS for significant detailed information regarding forfeited property.
- Foreclosed property is comprised of assets received in satisfaction of a loan receivable or as a result of payment of a claim under a guaranteed or insured loan (excluding commodities acquired under price support programs). All properties included in foreclosed property are assumed to be held for sale. Please refer to the individual financial statements of USDA and HUD for significant detailed information regarding foreclosed property.

## Note 8. Property, Plant, and Equipment, Net

### Property, Plant, and Equipment as of September 30, 2012

(In billions of dollars)	<u>Cost</u>		<u>Accumulated Depreciation/ Amortization</u>		<u>Net</u>	
	<u>Defense</u>	<u>All Others</u>	<u>Defense</u>	<u>All Others</u>	<u>Defense</u>	<u>All Others</u>
Buildings, structures, and facilities.....	248.9	234.0	120.9	123.4	128.0	110.6
Furniture, fixtures, and equipment.....	984.4	160.8	570.4	99.1	414.0	61.7
Construction in progress.....	42.8	50.8	N/A	N/A	42.8	50.8
Land.....	10.7	12.2	N/A	N/A	10.7	12.2
Internal use software.....	11.3	22.1	7.6	12.3	3.7	9.8
Assets under capital lease.....	0.9	3.1	0.5	1.5	0.4	1.6
Leasehold improvements.....	0.9	7.6	0.3	4.0	0.6	3.6
Other property, plant, and equipment.....	1.2	6.7	-	3.4	1.2	3.3
Subtotal.....	<u>1,301.1</u>	<u>497.3</u>	<u>699.7</u>	<u>243.7</u>	<u>601.4</u>	<u>253.6</u>
Total property, plant, and equipment, net.....		<u>1,798.4</u>		<u>943.4</u>		<u>855.0</u>

### Property, Plant, and Equipment as of September 30, 2011

(In billions of dollars)	<u>Cost</u>		<u>Accumulated Depreciation/ Amortization</u>		<u>Net</u>	
	<u>Defense</u>	<u>All Others</u>	<u>Defense</u>	<u>All Others</u>	<u>Defense</u>	<u>All Others</u>
Buildings, structures, and facilities.....	230.2	220.6	118.6	115.5	111.6	105.1
Furniture, fixtures, and equipment.....	945.1	161.6	511.1	98.3	434.0	63.3
Construction in progress.....	46.5	47.5	N/A	N/A	46.5	47.5
Land.....	10.6	11.9	N/A	N/A	10.6	11.9
Internal use software.....	10.0	19.9	6.9	10.7	3.1	9.2
Assets under capital lease.....	1.2	2.9	0.7	1.5	0.5	1.4
Leasehold improvements.....	1.0	6.9	0.5	3.6	0.5	3.3
Other property, plant, and equipment.....	1.2	6.2	-	3.1	1.2	3.1
Subtotal.....	<u>1,245.8</u>	<u>477.5</u>	<u>637.8</u>	<u>232.7</u>	<u>608.0</u>	<u>244.8</u>
Total property, plant, and equipment, net.....		<u>1,723.3</u>		<u>870.5</u>		<u>852.8</u>

For further information related to multi-use heritage assets, see Note 27—Stewardship Land and Heritage Assets.

DOD comprises approximately 70.4 percent of the Government's reported property, plant, and equipment, net, as of September 30, 2012. Refer to the individual financial statements of DOD, DOE, the Tennessee Valley Authority (TVA), GSA, the Department of Interior (DOI), VA, DHS, USPS, Department of State, and DOT for significant detailed information on the useful lives and related capitalization thresholds for property, plant, and equipment. These agencies comprise 93.9 percent of the Government's total cost of property, plant, and equipment net of \$855.0 billion as of September 30, 2012.







<b>Debt and Equity Securities as of September 30, 2012, and 2011</b>		
(In billions of dollars)	<b>By Agency</b>	
	<b>2012</b>	<b>2011</b>
<b>Debt and Equity Securities:</b>		
Pension Benefit Guaranty Corporation .....	52.8	47.4
Railroad Retirement Board .....	22.9	21.5
Department of the Treasury .....	18.0	26.7
Tennessee Valley Authority .....	9.5	8.6
All Other .....	7.0	6.4
Total Securities and Investments .....	110.2	110.6

These debt and equity securities do not include nonmarketable Treasury securities, which have been eliminated in consolidation. Held-to-maturity debt and equity securities are reported at amortized cost, net of unamortized discounts and premiums. Available-for-sale debt and equity securities are reported at fair value. Trading debt and equity securities are reported at fair value. The Pension Benefit Guaranty Corporation (PBGC) and the TVA invest primarily in fixed maturity and equity securities, classified as trading. Treasury invests primarily in fixed maturity and equity securities, classified as available-for-sale securities. Treasury's Exchange Stabilization Fund invests primarily in foreign fixed maturity debt, with a fair value of \$15.4 billion and \$15.8 billion as of September 30, 2012, and 2011, respectively. The General Fund also owns shares of AIG common stock. This non-TARP investment has a fair value of \$2.6 billion and \$10.9 billion as of September 30, 2012, and 2011, respectively. For more information on this non-TARP investment in AIG, refer to Note 6—Non-TARP Investments in American International Group, Inc. The National Railroad Retirement Investment Trust (NRRIT), on behalf of the RRB, manages and invests railroad retirement assets that are to be used to pay retirement benefits to the Nation's railroad workers under the Railroad Retirement Program. As an investment company, NRRIT is subject to different accounting standards that do not require the classifications presented above. NRRIT's total debt and equity securities are presented as a separate line item. Please refer to NRRIT's financial statements for more detailed information concerning this specific investment information. The TVA balance includes \$7.2 billion and \$7.0 billion as of September 30, 2012, and 2011, respectively, for the Tennessee Valley Authority Retirement System. Please refer to the individual financial statements of PBGC, NRRIT, Treasury, and TVA for more detailed information related to debt and equity securities. These agencies comprise 93.7 percent of the total reported debt and equity securities of \$110.2 billion as of September 30, 2012.

## Note 10. Derivatives

Derivatives are financial instruments that entities use to hedge their particular exposure to some sort of financial risk. These financial risks include interest rate risk, market price risk, credit risk, foreign exchange risk, and commodity risk. As FASAB (which determines GAAP for Federal entities) is silent on this issue, the accounting for derivative instruments is governed by FASB ASC Topic 815, *Derivatives and Hedging*, which aims to highlight to financial statement users additional disclosures on an entity's objectives in its use of derivatives and the method of accounting for such financial instruments. Derivatives are accounted for at market value in accordance with this standard. Derivatives are marked to market with changes in value reported within financial income. The hedge strategy (i.e., fair value, cashflow, or foreign currency) employed determines the financial statement impact on their statement of operations and net position. Per ASC Topic 815, the fair value of derivative instruments shall be presented on a gross basis when they are subject to master netting agreements.

PBGC uses derivatives to mitigate investment risks, enhance investment returns (derivatives are not used to leverage investment portfolios) and as a liquid and cost efficient substitute for positions in physical securities. PBGC utilizes a no hedging designation which results in the gain or loss on a derivative instrument being recognized currently in earnings. PBGC elects to net its derivative receivables and derivative payables and the related cash collateral received for its non-exchange derivative contracts subject to International Swaps and Derivatives Association, Inc. master agreements. As of September 30, 2012, PBGC had \$0.0 billion of derivatives in an asset position (recorded in other assets). PBGC had \$0.1 billion of derivatives in an asset position (recorded in other assets) as of September 30, 2011, and \$(0.01) billion of derivatives in a liability position (recorded in other liabilities) as of September 30, 2012, and 2011.

Other than certain derivative instruments in investment funds, TVA uses derivatives purely for hedging purposes and not for speculative purposes. The accounting for changes in fair value of these instruments depends on whether TVA uses regulatory accounting to defer the derivative gains and losses, and whether the derivative instrument qualifies for hedge accounting treatment. As of September 30, 2012, and 2011, respectively, TVA had \$0.2 billion and \$0.4 billion worth of derivatives in an asset position (recorded in other assets), and \$2.4 billion and \$2.1 billion worth of derivatives in a liability position (recorded in other liabilities).

The gain/(loss) on derivatives was \$0.1 billion and \$0.1 billion for PBGC and \$(0.4) billion and \$(0.1) billion for TVA for fiscal years 2012 and 2011, respectively.

Please refer to the individual financial statements of PBGC and TVA for more detailed information related to derivatives.

## Note 11. Investments in and Liabilities to Government-Sponsored Enterprises

Congress established Fannie Mae and Freddie Mac as GSEs to support the supply of mortgage loans. A key function of the GSEs is to package purchased mortgages into securities, which are subsequently sold to investors. Leading up to the financial crisis, increasingly difficult conditions in the housing market challenged the soundness and profitability of the GSEs, thereby undermining the entire housing market. This led Congress to pass the HERA. This Act created the FHFA, with enhanced regulatory authority over the GSEs, and provided the Secretary of the Treasury with certain authorities intended to ensure the financial stability of the GSEs, if necessary. In September 2008, FHFA placed the GSEs under conservatorship and Treasury entered into a SPSPA with each GSE. These actions were taken to preserve the GSEs' assets, ensure a sound and solvent financial condition, and mitigate systemic risks that contributed to current market instability. The SPSPAs were amended in August 2012 (the amended SPSPAs) and changed, among other things, the basis by which quarterly dividends are paid by the GSEs to the U.S. Government. The dividend change in the amended SPSPAs is effective commencing with the quarter ending March 31, 2013.

The actions taken by Treasury thus far are temporary, as defined by section 1117 of HERA, and are intended to provide financial stability. The purpose of Treasury's actions is to maintain the solvency of the GSEs so they can continue to fulfill their vital roles in the home mortgage market while the Administration and Congress determine what structural changes should be made. The FHFA director may terminate the conservatorship if safe and solvent conditions can be established. Draws under the SPSPAs are designed to ensure the GSEs maintain positive net worth as a result of any net losses from operations, and also meet taxpayer dividend requirements under the SPSPAs. The SPSPAs were structured to ensure any draws result in an increased nominal investment as further discussed below. Per SFFAC No. 2, *Entity and Display*, these entities meet the criteria of "bailed out" entities. Accordingly, the Government has not consolidated them into the financial statements, but included disclosure of the relationship(s) with the bailed out entities and any actual or potential material costs or liabilities in the consolidated financial statements.

### Senior Preferred Stock Purchase Agreements (SPSPAs)

Under the SPSPAs, Treasury initially received from each GSE: (1) 1,000,000 shares of non-voting variable liquidation preference senior preferred stock with a liquidation preference value of \$1,000 per share and (2) a non-transferable warrant for the purchase, at a nominal cost, of 79.9 percent of common stock on a fully-diluted basis. The warrants expire on September 7, 2028. Through December 31, 2012, the senior preferred stock accrues dividends at 10.0 percent per year, payable quarterly. Under the amended SPSPAs, the quarterly dividend payment will change from a 10.0 percent per annum fixed rate dividend to an amount equivalent to the GSE's positive net worth above a capital reserve amount. The capital reserve amount is initially set at \$3.0 billion for calendar year 2013, and declines by \$600 million at the beginning of each calendar year thereafter until it reaches zero by calendar year 2018. The GSEs will not pay a quarterly dividend if their positive net worth is not above the required capital reserve threshold; in such cases, the Treasury may be required to provide funding pursuant to the amended SPSPAs.

Cash dividends of \$18.4 billion and \$15.6 billion were received during fiscal years ended September 30, 2012, and 2011, respectively. In addition, beginning in fiscal year 2011, the GSEs were scheduled to begin paying Treasury a Periodic Commitment Fee (PCF) on a quarterly basis, payable in cash or via an increase to the liquidation preference. This fee may be waived by Treasury for up to 1 year at a time, if warranted by adverse mortgage market conditions. Treasury waived the PCF payments for the calendar years 2012 and 2011 given that the imposition of the PCF at that time would not fulfill its intended purpose of generating increased compensation to the Government. Commencing January 1, 2013, the PCF will no longer be required pursuant to the amended SPSPAs.

The SPSPAs, which have no expiration date, provide that Treasury will disburse funds to the GSEs if at the end of any quarter, the FHFA determines that the liabilities of either GSE exceed its assets. The maximum amount available to each GSE under this agreement was originally \$100 billion in fiscal year 2008, was raised to \$200 billion in fiscal year 2009, and was replaced in fiscal year 2010 with a formulaic cap. This formulaic cap allows continued draws for a 3-year period ending December 31, 2012, at amounts that will automatically adjust upwards quarterly by the cumulative amount of any net deficits realized by either GSE and downward by the GSE's positive net worth, if any, as of December 31, 2012, but not below \$200 billion, and will become fixed at the end of the 3-year period. At the conclusion of the 3-year period, the remaining commitment will then be fully available to be

drawn per the terms of the agreements (referred to hereafter as the “Adjusted Caps”). Draws against the funding commitment of the SPSPAs do not result in the issuance of additional shares of senior preferred stock; instead the liquidation preference of the initial 1,000,000 shares is increased by the amount of the draw.

Actual payments to the GSEs for fiscal years ended September 30, 2012, and 2011, were \$18.5 billion and \$20.8 billion, respectively. Additionally, \$9.0 billion and \$316.2 billion were accrued as a contingent liability as of September 30, 2012, and 2011, respectively. This accrued contingent liability is based on the projected draws under the SPSPAs. It is undiscounted and does not take into account any of the offsetting dividends which may be received as a result of those draws.

OMB issued guidance to Treasury on October 7, 2009, allowing the use of fair value accounting for non-Federal securities beginning with reporting for fiscal year 2009. As a result, the GSE investments are reported at fair value as of September 30, 2012, and 2011. In accordance with SFFAS No. 7, the annual valuation is classified as usual and recurring and thus a change in value is recorded as an expense or revenue to the financial statements. Annual valuations are performed as of September 30 for the preferred stock and warrants.

### **Contingent Liabilities to GSEs**

As part of the fair valuation exercise, Treasury prepared a series of long-range forecasts through 2025 to determine what the implied amount of the total contingent liability to the GSEs under the SPSPAs would be as of September 30. Since future payments under the SPSPAs are deemed to be probable, Treasury estimated a contingent liability of \$9.0 billion as of September 30, 2012. This estimate reflects the projected equity deficits of the GSEs stemming from credit losses and contractual dividend requirements until December 31, 2012. The estimated contingent liability as of September 30, 2012, included several case scenarios which resulted in total SPSPA estimates ranging from \$3.5 billion (based on an “optimistic” case scenario) to \$22.4 billion (based on an “extreme” case scenario).

The \$9.0 billion contingent liability reported as of September 30, 2012, reflects Treasury’s best estimate. This compares to the \$316.2 billion contingent liability reported as of September 30, 2011, which was based on a range of \$309.6 billion to \$376.1 billion. At September 30, 2012, the maximum remaining potential commitment to the GSEs for the remaining life of the SPSPAs under the Adjusted Caps was estimated at \$282.3 billion, which was based upon case scenario estimates ranging from \$274.0 billion to \$291.5 billion. The recorded contingent liability of \$316.2 billion at September 30, 2011, constituted the maximum commitment payable under the Adjusted Caps, minus actual payments made through the end of that fiscal year. Such accruals are adjusted as new information develops or circumstances change. Based on the annual valuation of Treasury’s estimated future contingent liability, Treasury reduced its estimated liability by \$288.7 billion and \$22.9 billion at the end of fiscal years 2012 and 2011, respectively, via a reduction in expense. The significant reduction in this estimated liability at September 30, 2012, compared to 2011 is primarily due to a forecasted reduction in the amount of future draws needed by the GSEs as a result of the amended provisions of the SPSPAs. 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 anticipated dividend payments after the revision are lower than previously forecasted.

### **Senior Preferred Stock and Warrants for Common Stock**

In determining the fair value of the senior preferred stock and warrants for common stock, Treasury relied on the GSEs’ public filings and press releases concerning its financial statements, projection forecasts, monthly summaries, quarterly credit supplements, independent research regarding high-yield bond and preferred stock trading, independent research regarding the GSEs’ common stock trading, discussions with the GSE’s management, and other information pertinent to the fair valuations. Because of the nature of the instruments, which are not publicly traded and for which there is no comparable trading information available, the fair valuations rely on significant unobservable inputs that reflect assumptions about the expectations that market participants would use in pricing.

The fair value of the senior preferred stock considers the amount of forecasted dividend payments. The fair valuations assume that a hypothetical buyer would acquire the discounted dividend stream as of the transaction date. The significant decline in the fair value of the senior preferred stock at September 30, 2012, compared to 2011 is primarily due to a decrease in expected dividend payments and an increase in the discount rate used in the current year’s valuation to reflect more of the variable nature of the future cash flows anticipated as a result of the amended SPSPAs compared to the prior fiscal year.

The fair value of the warrants are impacted by the nominal exercise price and the large number of potential exercise shares, the market trading of the common stock that underlies the warrants as of September 30, the principal market, and the market participants. Other discounting factors are the holding period risk related directly to the amount of time that it will take to sell the exercised shares without depressing the market and the other activity under the SPSPA.

### **Regulatory Environment**

Pursuant to a provision within the Dodd Frank Act, the Secretary of the Treasury conducted a study and developed recommendations regarding the options for ending the conservatorship. In February 2011, the President delivered to Congress a report from the Secretary of the Treasury that provided recommendations regarding the options for ending the conservatorship and plans to wind down the GSEs. To date, Congress has not approved a plan to address the future of the GSEs, and thus the GSEs continue to operate under the direction of their conservator, the FHFA, whose stated planned objectives are to build a revitalized infrastructure for the secondary mortgage market and a continued gradual contraction of the GSEs presence in the secondary mortgage market.

In December 2011, Congress passed the Temporary Payroll Tax Cut Continuation Act of 2011 (TPTCCA), which included an increase in the GSEs' guarantee fees that would expire on October 1, 2021. Under TPTCCA, the amount of the fee increase shall not be less than an average increase of 10-basis points above the average fees imposed in 2011 for such guarantees. The increased fees are to be remitted to Treasury and not retained by the GSEs.

On September 28, 2012, the GSEs remitted to the Department an amount of \$35 million as the first payment of these increased fees covering the period of April 1, 2012, through June 30, 2012. This increase in guarantee fees did not affect the profitability of the GSEs during that time period.

As of September 30, 2012, and 2011, GSE investments consisted of the following:

<b>Investments in GSE as of September 30, 2012</b>			
(In billions of dollars)	<b>Gross Investments as of 9/30/12</b>	<b>Cumulative Valuation (Loss)</b>	<b>9/30/12 Fair Value</b>
Fannie Mae Senior Preferred Stock .....	117.0	(51.3)	65.7
Freddie Mac Senior Preferred Stock .....	72.1	(30.2)	41.9
Fannie Mae Warrants Common Stock .....	3.1	(2.0)	1.1
Freddie Mac Warrants Common Stock .....	2.3	(1.7)	0.6
Total GSE Investment .....	<u>194.5</u>	<u>(85.2)</u>	<u>109.3</u>
<b>Investments in GSE as of September 30, 2011</b>			
(In billions of dollars)	<b>Gross Investments as of 9/30/11</b>	<b>Cumulative Valuation (Loss)</b>	<b>9/30/11 Fair Value</b>
Fannie Mae Senior Preferred Stock .....	104.5	(26.7)	77.8
Freddie Mac Senior Preferred Stock .....	66.0	(12.4)	53.6
Fannie Mae Warrants Common Stock .....	3.1	(2.1)	1.0
Freddie Mac Warrants Common Stock .....	2.3	(1.7)	0.6
Total GSE Investment .....	<u>175.9</u>	<u>(42.9)</u>	<u>133.0</u>

## Note 12. Other Assets

### Other Assets as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
Advances and Prepayments .....	96.5	112.9
FDIC Receivable from Resolution Activity .....	18.9	29.3
Regulatory Assets .....	18.9	19.7
Other .....	23.3	17.4
Total Other Assets.....	157.6	179.3

Advances and prepayments are assets that represent funds disbursed in contemplation of the future performance of services, receipt of goods, the incurrence of expenditures, or the receipt of other assets. These include advances to contractors and grantees, travel advances, and prepayments for items such as rents, taxes, insurance, royalties, commissions, and supplies.

The Federal Deposit Insurance Corporation (FDIC) has the responsibility for resolving failed institutions in an orderly and efficient manner. The resolution process involves valuing a failing institution, marketing it, soliciting and accepting bid for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution through the closing process. FDIC records receivables for resolutions that include payments by the Deposit Insurance Fund to cover obligations to insured depositors, advances to receiverships and conservatorships for working capital, and administrative expenses paid on behalf of receiverships and conservatorships.

With regard to regulatory assets, the DOE's Power Marketing Authorities (PMAs) and the TVA record certain amounts as assets in accordance with FASB ASC Topic 980, *Regulated Operations*. The provisions of FASB ASC Topic 980 require that regulated enterprises reflect rate actions of the regulator in their financial statements, when appropriate. These rate actions can provide reasonable assurance of the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise. In order to defer incurred costs under FASB ASC Topic 980, a regulated entity must have the statutory authority to establish rates that recover all costs, and those rates must be charged to and collected from customers. If the PMAs' or TVA's rates should become market-based, FASB ASC Topic 980 would no longer be applicable, and all of the deferred costs under that standard would be expensed.

Other items included in "other" are purchased power generating capacity, deferred nuclear generating units, nonmarketable equity investments in international financial institutions, and the balance of assets held by the experience rated carriers participating in the Health Benefits and Life Insurance Program (pending disposition on behalf of OPM).

## Note 13. Accounts Payable

### Accounts Payable as of September 30, 2012, and 2011

(In billions of dollars)

	2012	2011
Department of Defense.....	19.5	26.1
Department of Veterans Affairs.....	9.7	1.1
Department of the Treasury.....	4.9	4.8
Department of Education.....	4.1	4.2
Department of Justice.....	4.1	2.5
Department of State.....	2.8	1.9
General Services Administration.....	2.0	2.7
Department of Agriculture.....	2.0	0.7
Department of Homeland Security.....	1.9	2.9
Tennessee Valley Authority.....	1.9	2.4
Agency for International Development.....	1.9	1.7
Department of Energy.....	1.7	1.8
U.S. Postal Service.....	1.7	1.7
National Aeronautics and Space Administration.....	1.4	1.4
Department of Housing and Urban Development.....	1.3	1.4
All other.....	4.3	6.1
Total accounts payable.....	<u>65.2</u>	<u>63.4</u>

Accounts payable includes amounts due for goods and property ordered and received, services rendered by other than Federal employees, accounts payable for cancelled appropriations, and non-debt related interest payable.



## Note 14. Federal Debt Securities Held by the Public and Accrued Interest

### Federal Debt Securities Held by the Public and Accrued Interest

(In billions of dollars)	Balance September 30, 2011	Net Change During Fiscal Year 2012	Balance September 30, 2012	Average Interest Rate	
				2012	2011
<b>Treasury securities (public):</b>					
Marketable securities:					
Treasury bills.....	1,475.6	137.4	1,613.0	0.1%	0.1%
Treasury notes.....	6,407.0	708.0	7,115.0	2.0%	2.3%
Treasury bonds.....	1,016.4	178.3	1,194.7	5.4%	5.8%
Treasury inflation-protected securities (TIPS).....	705.3	102.2	807.5	1.4%	1.9%
Total marketable Treasury securities.....	9,604.3	1,125.9	10,730.2		
Nonmarketable securities.....	522.7	16.7	539.4	2.1%	2.8%
Net unamortized premiums/ (discounts).....	(29.5)	10.3	(19.2)		
Total Treasury securities, net (public).....	10,097.5	1,152.9	11,250.4		
<b>Agency securities:</b>					
Tennessee Valley Authority.....	24.4	(0.4)	24.0		
All other agencies.....	0.3	-	0.3		
Total agency securities, net of unamortized premiums and discounts.....	24.7	(0.4)	24.3		
<b>Accrued interest payable</b> .....	<u>51.9</u>	<u>5.7</u>	<u>57.6</u>		
<b>Total Federal debt securities held by the public and accrued interest</b> .....	<u>10,174.1</u>	<u>1,158.2</u>	<u>11,332.3</u>		

Types of marketable securities:

Bills—Short-term obligations issued with a term of 1 year or less.

Notes—Medium-term obligations issued with a term of at least 1 year, but not more than 10 years.

Bonds—Long-term obligations of more than 10 years.

TIPS—Term of more than 5 years.

Federal debt securities held by the public outside the Government are held by individuals, corporations, State or local governments, FRBs, foreign governments, and other entities outside the Federal Government. The above table details Government borrowing primarily to finance operations and shows marketable and nonmarketable securities at face value less net unamortized premiums and discounts including accrued interest.

Securities that represent Federal debt held by the public are issued primarily by the Treasury and include:

- Interest-bearing marketable securities (bills, notes, bonds, and inflation-protected).
- Interest-bearing nonmarketable securities (government account series held by deposit and fiduciary funds, foreign series, State and local government series, domestic series, and savings bonds).
- Non-interest-bearing marketable and nonmarketable securities (matured and other).

Section 3111 of Title 31, United States Code (U.S.C.) authorizes the Secretary of the Treasury to use money received from the sale of an obligation and other money in the General Fund of the Treasury to buy, redeem, or refund, at or before maturity, outstanding bonds, notes, certificates of indebtedness, Treasury bills, or savings certificates of the Government. There were no buyback operations in fiscal years 2012 and 2011.

Gross Federal debt (with some adjustments) is subject to a statutory ceiling (i.e., the debt limit). Prior to 1917, the Congress approved each debt issuance. In 1917, to facilitate planning in World War I, Congress and the President first enacted a statutory 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, on August 2, 2011, Public Law 112-25 was enacted, which increased the statutory debt limit to \$14,694.0 billion on August 2, 2011, \$15,194.0 billion after close of business on September 21, 2011, and \$16,394.0 billion after close of business on January 27, 2012. Prior to the August 2011 and January 2012 increases, Treasury faced a period that required it to depart from its normal debt management procedures and to invoke legal authorities to avoid exceeding the statutory debt limit. As of September 30, 2012, and 2011, debt subject to the statutory debt limit was \$16,027.0 billion and \$14,746.6 billion, respectively. The debt subject to the limit includes Treasury securities held by the public and Government guaranteed debt of Federal agencies (shown in the table above) and intragovernmental debt holdings (shown in the following table). Please see Note 28—Subsequent Events for additional information.

**Intragovernmental Debt Holdings: Federal Debt Securities  
Held as Investments by Government Accounts as of September 30, 2012,  
and 2011**

(In billions of dollars)	Balance 2011	Net Change During Fiscal Year 2012	Balance 2012
Social Security Administration, Federal Old-Age and Survivors Insurance Trust Fund .....	2,492.5	94.2	2,586.7
Office of Personnel Management, Civil Service Retirement and Disability Fund .....	803.8	22.7	826.5
Department of Defense, Military Retirement Fund.....	326.0	50.4	376.4
Department of Health and Human Services, Federal Hospital Insurance Fund.....	245.9	(17.6)	228.3
Department of Defense, Medicare-Eligible Retiree Health Care Fund .....	161.7	14.4	176.1
Social Security Administration, Federal Disability Insurance Trust Fund .....	162.0	(29.7)	132.3
Department of Health and Human Services, Federal Supplementary Medical Insurance Trust Fund.....	70.4	(1.1)	69.3
Department of Energy, Nuclear Waste Disposal Fund.....	48.6	1.0	49.6
Office of Personnel Management, Postal Service Retiree Health Benefits Fund .....	43.7	1.6	45.3
Office of Personnel Management, Employees Life Insurance Fund.....	39.7	1.6	41.3
Federal Deposit Insurance Corporation Funds .....	45.6	(4.6)	41.0
Department of the Treasury, Exchange Stabilization Fund.....	22.7	-	22.7
Office of Personnel Management, Employees Health Benefits Fund.....	19.2	2.1	21.3
Pension Benefit Guaranty Corporation Fund .....	21.0	0.1	21.1
Department of Labor, Unemployment Trust Fund.....	16.0	4.7	20.7
Department of State, Foreign Service Retirement and Disability Fund .....	16.4	0.5	16.9
Department of Transportation, Airport and Airway Trust Fund .....	8.6	1.8	10.4
National Credit Union Share Insurance Fund .....	10.7	(0.4)	10.3
Department of Transportation, Highway Trust Fund.....	16.3	(6.3)	10.0
All other programs and funds .....	92.5	(2.1)	90.4
Subtotal.....	4,663.3	133.3	4,796.6
Total Net Unamortized Premiums/Discounts for Intragovernmental.....	47.6	8.7	56.3
Total intragovernmental debt holdings, net .....	4,710.9	142.0	4,852.9

Intragovernmental debt holdings represent the portion of the gross Federal debt held as investments by Government entities such as trust funds, revolving funds, and special funds. This includes trust funds that are earmarked funds. For more information on earmarked funds, see Note 24—Earmarked Funds. These intragovernmental debt holdings are eliminated in the consolidation of these financial statements.

## Note 15. Federal Employee and Veteran Benefits Payable

### Federal Employee and Veteran Benefits Payable as of September 30, 2012, and 2011

(In billions of dollars)	Civilian		Military		Total	
	2012	2011	2012	2011	2012	2011
Pension and accrued benefits .....	1,772.3	1,619.7	1,482.0	1,361.3	3,254.3	2,981.0
Post-retirement health and accrued benefits .....	328.1	342.5	833.3	842.3	1,161.4	1,184.8
Veterans compensation and burial benefits .....	N/A	N/A	1,761.6	1,533.7	1,761.6	1,533.7
Life insurance and accrued benefits .....	47.2	44.6	10.6	11.1	57.8	55.7
FECA benefits .....	27.0	24.2	8.6	8.3	35.6	32.5
Liability for other benefits .....	0.8	1.6	2.5	2.9	3.3	4.5
Total Federal employee and veteran benefits payable.....	<u>2,175.4</u>	<u>2,032.6</u>	<u>4,098.6</u>	<u>3,759.6</u>	<u>6,274.0</u>	<u>5,792.2</u>

### Change in Pension and Accrued Benefits

(In billions of dollars)	Civilian		Military		Total	
	2012	2011	2012	2011	2012	2011
<b>Actuarial accrued pension liability, beginning of fiscal year .....</b>	1,619.7	1,632.9	1,361.3	1,262.7	2,981.0	2,895.6
<b>Pension expense:</b>						
Expected normal costs .....	36.3	36.8	34.3	24.9	70.6	61.7
Interest on pension liability during the period.....	74.4	78.3	64.8	62.6	139.2	140.9
Prior (or past) service cost from plan amendments or new plans.....	0.1	-	-	-	0.1	-
Actuarial (gains)/losses (from experience) .....	9.7	(70.6)	(3.2)	0.1	6.5	(70.5)
Actuarial (gains)/losses (from assumption changes).....	109.6	15.9	77.2	62.0	186.8	77.9
Total pension expense.....	230.1	60.4	173.1	149.6	403.2	210.0
Less benefits paid.....	(77.5)	(73.6)	(52.4)	(51.0)	(129.9)	(124.6)
<b>Actuarial accrued pension liability, end of fiscal year .....</b>	<u>1,772.3</u>	<u>1,619.7</u>	<u>1,482.0</u>	<u>1,361.3</u>	<u>3,254.3</u>	<u>2,981.0</u>

### Change in Post-Retirement Health and Accrued Benefits

(In billions of dollars)	Civilian		Military		Total	
	2012	2011	2012	2011	2012	2011
<b>Actuarial accrued post-retirement health benefits liability, beginning of fiscal year</b> .....	342.5	355.5	842.3	904.7	1,184.8	1,260.2
<b>Post-retirement health benefits expense:</b>						
Prior (and past) service costs from plan amendments or new plans .....	-	-	(31.9)	(15.9)	(31.9)	(15.9)
Normal costs .....	13.8	14.5	21.4	24.0	35.2	38.5
Interest on liability .....	16.4	17.8	41.7	45.8	58.1	63.6
Actuarial (gains)/losses (from experience) .....	(21.2)	(17.9)	(12.3)	(1.1)	(33.5)	(19.0)
Actuarial (gains)/losses (from assumption changes) .....	(9.8)	(13.8)	(6.8)	(94.0)	(16.6)	(107.8)
Total post-retirement health benefits expense .....	(0.8)	0.6	12.1	(41.2)	11.3	(40.6)
Less claims paid .....	(13.6)	(13.6)	(21.1)	(21.2)	(34.7)	(34.8)
<b>Actuarial accrued post-retirement health benefits liability, end of fiscal year</b> .....	<u>328.1</u>	<u>342.5</u>	<u>833.3</u>	<u>842.3</u>	<u>1,161.4</u>	<u>1,184.8</u>

The Government offers its employees life and health insurance, as well as retirement and other benefits. The liabilities for these benefits, which include both actuarial amounts and amounts due and payable to beneficiaries and health care carriers, apply to civilian and military employees.

OPM administers the largest civilian plan. DOD administers the largest military plan. Other significant pension plans with more than \$10 billion in accrued benefits payable include those of the Coast Guard (DHS), Foreign Service (Department of State), TVA, USPS, and HHS.

### Change in Civilian Life Insurance and Accrued Benefits

(In billions of dollars)	2012	2011
<b>Actuarial accrued life insurance benefits liability, beginning of fiscal year</b> .....	44.6	44.0
<b>Life insurance benefits expense:</b>		
New entrant expense .....	0.3	0.4
Interest on liability .....	2.1	2.1
Actuarial (gains)/losses (from experience) .....	-	(0.5)
Actuarial (gains)/losses (from assumption changes) .....	0.7	(0.9)
Total life insurance benefits expense .....	3.1	1.1
Less costs paid .....	(0.5)	(0.5)
<b>Actuarial accrued life insurance benefits liability, end of fiscal year</b> .....	<u>47.2</u>	<u>44.6</u>

### Significant Long-Term Economic Assumptions Used in Determining Pension Liability and the Related Expense

	Civilian				Military	
	2012		2011		2012	2011
	FERS	CSRS	FERS	CSRS		
Rate of interest.....	4.70%	4.30%	4.90%	4.60%	4.60%	4.80%
Rate of inflation .....	2.50%	2.50%	2.40%	2.40%	2.60%	2.50%
Projected salary increases .....	2.60%	2.60%	3.10%	3.10%	3.00%	3.30%
Cost of living adjustment.....	2.00%	2.50%	1.90%	2.40%	-	-

### Significant Long-Term Economic Assumptions Used in Determining Post-Retirement Health Benefits and the Related Expense

	Civilian		Military	
	2012	2011	2012	2011
	Rate of interest.....	4.70%	4.90%	4.60%
Single equivalent medical trend rate.....	-	-	5.10%	5.20%
Ultimate medical trend rate .....	4.40%	4.35%	5.35%	5.25%

### Significant Long-Term Economic Assumptions Used in Determining Life Insurance Benefits and the Related Expense

	Civilian	
	2012	2011
Rate of interest.....	4.50%	4.80%
Rate of increase in salary.....	2.60%	3.10%

With the implementation of SFFAS No. 33, *Pension, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates*, agencies are required to separately present gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, ORB, and OPEB on the Statement of Net Cost. SFFAS No. 33 also provides a standard for selecting the discount rate assumption for present value estimates of Federal employee pension, ORB, and OPEB liabilities. In addition, SFFAS No. 33 provides a standard for selecting the valuation date for estimates of Federal employee pension, ORB, and OPEB liabilities that will establish a consistent method for such measurements.

DOD's long-term ultimate medical trend rate for post-retirement health benefits liability is 5.35 percent for fiscal year 2012 and 5.25 percent for fiscal year 2011. For disclosure and comparison purposes, DOD's estimate of a single equivalent medical trend rate for fiscal year 2012 is 5.10 percent and for fiscal year 2011 is 5.2 percent, which is an approximation of the single equivalent rate that would produce that same actuarial liability as the actual rates used. Please refer to the individual financial statements of DOD for further details regarding Military Retirement Health Benefits-Medical Trend.

## Civilian Employees

### Pensions

OPM administers the largest civilian pension plan, which covers substantially all full-time, permanent civilian Federal employees. This plan includes two components of defined benefits. These are the Civil Service Retirement System (CSRS) and the Federal Employees' Retirement System (FERS). The basic benefit components of the CSRS and the FERS are financed and operated through the Civil Service Retirement and Disability Fund (CSRDF).

CSRDF monies are generated primarily from employees' contributions, agency contributions, payments from the General Fund, and interest on investments in Treasury securities. See Note 24—Earmarked Funds.

The Federal Retirement Thrift Investment Board administers the Thrift Savings Plan (TSP) Fund. The TSP Fund investment options include two fixed income funds (the G and F Funds), three stock funds (the C, S, and I Funds) and five lifecycle funds (L 2050, L 2040, L 2030, L 2020, and L Income). The L Funds diversify participant accounts among the G, F, C, S, and I Funds, using professionally determined investment mixes (allocations) that are tailored to different time horizons. Treasury securities held in the G Fund are included in Federal debt securities held by the public and accrued interest on the Balance Sheets. The G Fund held \$153.9 billion and \$139.3 billion in non-marketable Treasury securities as of September 30, 2012, and 2011, respectively.

### Post-Retirement Health Benefits

The post-retirement civilian health benefit liability is an estimate of the Government's future cost of providing post-retirement health benefits to current employees and retirees. Although active and retired employees pay insurance premiums under the Federal Employees Health Benefits Program (FEHB), these premiums cover only a portion of the costs. The OPM actuary applies economic assumptions to historical cost information to estimate the liability.

### Life Insurance Benefits

One of the largest other employee benefits is the Federal Employee Group Life Insurance (FEGLI) Program. Employee and annuitant contributions and interest on investments fund a portion of this liability. The actuarial life insurance liability is the expected present value of future benefits to pay to, or on behalf of, existing FEGLI participants. The OPM actuary uses interest rate, inflation, and salary increase assumptions that are consistent with the pension liability.

## Workers' Compensation Benefits

The DOL determines both civilian and military agencies' liabilities for future workers' compensation benefits for civilian Federal employees, as mandated by the Federal Employees' Compensation Act (FECA), for death, disability, medical, and miscellaneous costs for approved compensation cases, and a component for incurred, but not reported, claims. The FECA liability is determined annually using historical benefit payment patterns related to injury years to predict the ultimate payments. These estimated payments have been discounted to present value using OMB's interest rate assumptions for 10-year U.S. Treasury notes. For 2012, a 2.29 percent interest rate was assumed in year one and 3.14 percent was assumed for year two and thereafter.

The DOL calculates the FECA liability using wage inflation factors, cost of living adjustments (COLA), and medical inflation factors (Consumer Price Index—Medical or (CPIM)). The table below reflects the compensation COLAs and CPIMs used in the estimations for various charge-back years.

Fiscal Year	COLA	CPIM
2013	2.83%	3.65%
2014	2.03%	3.66%
2015	1.93%	3.72%
2016	2.00%	3.73%
2017+	2.03%	3.80%

## Military Employees (Including Veterans)

### Pensions

The DOD Military Retirement Fund finances military retirement and survivor benefit programs. The increase in the Military Retirement Pension liability is due to additional benefit accruals (normal cost), interest on the pension liability and assumption and benefit changes. Liabilities in the future will depend on expected changes due to interest and benefit accruals, future benefit changes, assumption changes, and actuarial experience.

This Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current years' service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt per Public Law 108-136; and investment income.

The military retirement system consists of a funded, noncontributory, defined benefit plan. It applies to military personnel (Departments of Army, Navy, Air Force, and the Marine Corps). This system includes nondisability retirement pay, disability retirement pay, and survivor annuity programs. Military personnel who remain on active duty for 20 years or longer are eligible for retirement. There are three different retirement benefit formulas that are currently being used by the military: Final Pay, High-3 Year Average, and Career Status Bonus/Military Retirement Reform Act of 1986. The date an individual enters the military determines which retirement system they would fall under and if they have the option to pick their retirement system. For more information on these benefits, see DOD's Websites <http://www.dfas.mil/retiredmilitary/plan/estimate/csbredux.html>.

### Post-Retirement Health Benefits

Military retirees and their dependents are entitled to health care in military medical facilities if a facility can provide the needed care. Prior to becoming Medicare eligible, military retirees and their dependents also are entitled to participate in TRICARE, which reimburses (net of beneficiary copay and deductible requirements) for the cost of health care from civilian providers. TRICARE options are available in indemnity, preferred provider organization, and health maintenance organization (HMO) designs.

Since fiscal year 2002, TRICARE, as second payer to Medicare, covers military retirees and their dependents after they become Medicare eligible. This TRICARE coverage for Medicare eligible beneficiaries requires that the beneficiary enroll in Medicare Part B and is referred to as TRICARE for Life (TFL). Health care under TFL can be obtained from military medical facilities on an "as available" basis or from civilian providers. Military retiree health care actuarial liability figures include costs incurred in military medical facilities, as well as claims paid to civilian providers and certain administrative costs. Costs paid to civilian providers are net of Medicare's portion of the cost.

Chapter 56 of Title 10, United States Code (U.S.C.) created the DOD Medicare-Eligible Retiree Health Care Fund, which became operative on October 1, 2002. The purpose of this fund is to account for the health benefits of Medicare-eligible military retirees, their dependents, and survivors who are Medicare eligible. The Fund receives contributions from the Uniformed Services and Treasury, as well as interest earnings on its investments and pays costs incurred in military medical facilities, as well as claims for care provided by civilian providers under TFL, administration costs associated with processing the TFL claims, and capitated payments for coverage provided by U.S. Family Health Plans.

In addition to the health care benefits for civilian and military retirees and their dependents, the VA also provides medical care to veterans on an "as available" basis, subject to the limits of the annual appropriations. In accordance with 38 CFR 17.36 (c), VA's Secretary makes an annual enrollment decision that defines the veterans, by priority, who will be treated for that fiscal year subject to change based on funds appropriated, estimated collections, usage, the severity index of enrolled veterans, and changes in cost. Accordingly, VA recognizes the medical care expenses in the period the medical care services are provided. For the fiscal years 2009 through 2012, the average medical care cost per year was \$39.0 billion.

### Veterans Compensation and Burial Benefits

The Government compensates disabled veterans and their survivors. Veterans compensation is payable as a disability benefit or a survivor's benefit. Entitlement to compensation depends on the veteran's disabilities having been incurred in, or aggravated during, active military service; death while on duty; or death resulting from service-connected disabilities, if not on active duty.

Burial benefits include a burial and plot or interment allowance payable for a veteran who, at the time of death, is qualified to receive compensation or a pension, or whose death occurred in a VA facility.



The liability for veterans' compensation and burial benefits payable increased by \$227.9 billion in fiscal year 2012. Substantially all the \$227.9 billion increase in the Federal Employee and Veterans Benefits Liabilities relates to 1) changes in experience related primarily to increased disability claims filed and processed for presumptive disability benefits associated with Vietnam Veterans, including Agent Orange and 2) changes in actuarial liability assumptions used to project future cash flows related primarily to higher disability claims rates.

Several significant actuarial assumptions were used in the valuation of compensation, pension, and burial benefits to calculate the present value of the liability. A liability was recognized for the projected benefit payments to: (1) those beneficiaries, including veterans and survivors, currently receiving benefit payments; (2) current Veterans who will in the future become beneficiaries of the compensation and pension programs; and (3) a proportional share of those in active military service as of the valuation date who will become veterans in the Future.

The Veterans Compensation and Burial benefits liability is a valuation of a long period of estimated cashflows. As a result, changes in long-term assumptions can have a dramatic effect on the liability. If those changes to long-term assumptions are in different directions from one period to the next, the changes to net cost from period to period are more pronounced as demonstrated over the past several years.

<b>Change in Veterans Compensation and Burial Benefits</b>						
(In billions of dollars)	<b>Compensation</b>		<b>Burial</b>		<b>Total</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Actuarial accrued liability beginning of fiscal year .....	1,529.2	1,470.5	4.5	4.3	1,533.7	1,474.8
Current Year Expense:						
Interest on the liability balance .....	69.3	69.5	0.2	0.2	69.5	69.7
Prior (and past) service costs from program amendments or new programs during the period .....	0.4	-	-	-	0.4	-
Actuarial (gain)/losses (from experience).....	61.7	(14.4)	(0.1)	(0.1)	61.6	(14.5)
Actuarial (gain)/losses (from assumption changes).....	149.2	55.6	0.1	0.3	149.3	55.9
Total current year expense.....	280.6	110.7	0.2	0.4	280.8	111.1
Less benefits paid.....	(52.7)	(52.0)	(0.2)	(0.2)	(52.9)	(52.2)
Actuarial accrued liability end of fiscal year .....	<u>1,757.1</u>	<u>1,529.2</u>	<u>4.5</u>	<u>4.5</u>	<u>1,761.6</u>	<u>1,533.7</u>
<b>Significant Economic Assumptions Used in Determining Veterans Compensation and Burial Benefits as of September 30, 2012, and 2011</b>						
			<b>2012</b>		<b>2011</b>	
Rate of interest .....			4.31%		4.53%	
Rate of inflation.....			2.61%		2.78%	

### Life Insurance Benefits

The largest veterans' life insurance programs consist of the following:

- National Service Life Insurance (NSLI) covers policyholders who served during World War II.
- Veterans' Special Life Insurance (VSLI) was established in 1951 to meet the insurance needs of veterans who served during the Korean Conflict and through the period ending January 1, 1957.
- Veterans' Reopened Insurance (VRI), which provided a 1-year reopening for insurance coverage in 1965 for those eligible to have obtained NSLI or VSLI and were disabled.

The components of veteran life insurance liability for future policy benefits are presented below.

<b>Veterans Life Insurance Liability as of September 30, 2012, and 2011</b>		
(In billions of dollars)	<b>2012</b>	<b>2011</b>
<b>Insurance death benefits:</b>		
NSLI .....	5.7	6.2
VSLI .....	1.5	1.5
VRI .....	0.2	0.2
Other .....	0.7	0.6
Total death benefits.....	<u>8.1</u>	<u>8.5</u>
Death benefit annuities.....	0.1	0.1
Disability income and waiver .....	0.7	0.7
Insurance dividends payable.....	1.6	1.7
Unearned premiums.....	0.1	0.1
Total veterans life insurance liability.....	<u><u>10.6</u></u>	<u><u>11.1</u></u>

Insurance dividends payable consists of dividends left on a deposit with VA, related interest payable, and dividends payable to policyholders.

The VA supervises Servicemembers Group Life Insurance and Veterans Group Life Insurance programs that provide life insurance coverage to members of the uniformed armed services and veterans who served during the Vietnam era or thereafter. The VA also provides certain veterans and/or their dependents with pension benefits, based on annual eligibility reviews, if the veteran died or was disabled for nonservice-related causes. The actuarial present value of the future liability for pension benefits is a non-exchange transaction and is not required to be recorded on the Balance Sheet. The projected amounts of future payments for pension benefits (presented for informational purposes only) as of September 30, 2012, and 2011, were \$92.8 billion and \$89.2 billion, respectively.

## Note 16. Environmental and Disposal Liabilities

### Environmental and Disposal Liabilities as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
<b>Department of Energy:</b>		
Environmental and disposal liabilities .....	268.4	250.6
<b>Department of Defense:</b>		
Environmental Restoration .....	28.4	29.4
Disposal of Weapon Systems Program .....	24.5	24.9
Environmental Corrective Other .....	5.4	5.7
Base Realignment and Closure.....	4.3	4.8
Total Department of Defense.....	62.6	64.8
<b>All other agencies</b> .....	8.0	8.7
Total environmental and disposal liabilities .....	339.0	324.1

During World War II and the Cold War, DOE (or predecessor agencies) developed a massive industrial complex to research, produce, and test nuclear weapons. This included nuclear reactors, chemical-processing buildings, metal machining plants, laboratories, and maintenance facilities that manufactured tens of thousands of nuclear warheads and conducted more than one thousand nuclear tests.

At all sites where these activities took place, some environmental contamination occurred. This contamination was caused by the production, storage, and use of radioactive materials and hazardous chemicals, which resulted in contamination of soil, surface water, and groundwater. The environmental legacy of nuclear weapons production also includes thousands of contaminated buildings and large volumes of waste and special nuclear materials requiring treatment, stabilization, and disposal.

Estimated cleanup costs at sites for which there are no current feasible remediation approaches, such as the Nevada nuclear test site, are excluded from the estimates, although applicable stewardship and monitoring costs for these sites are included. DOE has not been required through regulation to establish remediation activities for these sites.

Estimating DOE's environmental cleanup liability requires making assumptions about future activities and is inherently uncertain. The future course of DOE's environmental cleanup and disposal will depend on a number of fundamental technical and policy choices, many of which have not been made. The sites and facilities could be restored to a condition suitable for any desirable use, or could be restored to a point where they pose no near-term health risks. Achieving the former conditions would have a higher cost, but may or may not, warrant the costs, or be legally required. The environmental liability estimates include contingency estimates intended to account for the uncertainties associated with the technical cleanup scope of the program.

DOE's environmental and disposal liabilities estimates are dependent on annual funding levels and achievement of work as scheduled. Congressional appropriations at lower than anticipated levels or unplanned delays in project completion would cause increases in life-cycle costs.

DOE's environmental and disposal liabilities also include the estimated cleanup and post-closure responsibilities, including surveillance and monitoring activities, soil and groundwater remediation, and disposition of excess material for sites. The Department is responsible for the post-closure activities at many of the closure sites as well as other sites. The costs for these post-closure activities are estimated for a period of 75 years after the balance sheet date, i.e., through 2087 in fiscal year 2012 and through 2086 in fiscal year 2011. While some post-cleanup monitoring and other long-term stewardship activities post 2087 are included in the liability, there are others the Department expects to continue beyond 2087 for which the costs cannot reasonably be estimated.

A portion of DOE's environmental and disposal liabilities at various field sites includes anticipated costs for facilities managed by DOE's ongoing program operations which will ultimately require stabilization, deactivation and decommissioning. The estimate is largely based upon a cost-estimating model. Site specific estimates are used in lieu of the cost-estimating model, when available. Cost estimates for ongoing program facilities are updated each

year. For facilities newly contaminated since fiscal year 1997, cleanup costs allocated to future periods and not included in environmental and disposal liabilities amounted to \$808.0 million and \$920.0 million for fiscal years 2012 and 2011, respectively.

Please refer to the financial statements of the DOE for significant detailed information regarding DOE's environmental and disposal liabilities, including cleanup costs.

DOD follows the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), Superfund Amendments and Reauthorization Act, Resource Conservation and Recovery Act (RCRA) and other applicable Federal or State laws to clean up contamination. The CERCLA and RCRA require the DOD to clean up contamination in coordination with regulatory agencies, current owners of property damaged by the Department, and third parties that have a partial responsibility for the environmental restoration. Failure to comply with agreements and legal mandates puts the DOD at risk of incurring fines and penalties.

DOD must restore active installations, installations affected by base realignment and closure, and other areas formerly used as Defense sites. DOD also bears responsibility for disposal of chemical weapons and environmental costs associated with the disposal of weapons systems (primarily nuclear powered aircraft carriers and submarines).

DOD uses engineering estimates and independently validated models to estimate environmental costs. The engineering estimates are used after obtaining extensive data during the remedial investigation/feasibility phase of the environmental project.

For general PP&E placed into service after September 30, 1997, DOD expenses associated environmental costs systematically over the life of the asset using two methods: physical capacity for operating landfills and life expectancy in years for all other assets. The Department expenses the full cost to clean up contamination for stewardship property, plant, and equipment at the time the asset is placed into service. DOD has expensed the costs for cleanup associated with general property, plant, and equipment placed into service before October 1, 1997, except for costs intended to be recovered through user charges; for those costs, DOD has expensed cleanup costs associated with that portion of the asset life that has passed since it was placed into service. DOD systematically recognizes the remaining cost over the remaining life of the asset. The unrecognized portion of the cleanup cost associated with general property, plant, and equipment is \$3.2 billion and \$2.9 billion for fiscal years 2012 and 2011, respectively. Not all components of DOD are able to compile the necessary information for this disclosure, thus the amount reported may not accurately reflect DOD's total unrecognized costs associated with general property, plant, and equipment. DOD is implementing procedures to address these deficiencies.

DOD is unable to estimate and report a liability for environmental restoration and corrective action for buried chemical munitions and agents, because the extent of the buried chemical munitions and agents is unknown at this time. DOD is also unable to provide a complete estimate for the Formerly Utilized Sites Remedial Action Program. DOD has ongoing studies and will update its estimate as additional liabilities are identified. DOD has the potential to incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. However, DOD is unable to provide a reasonable estimate at this time because the extent of required restoration is unknown.

Please refer to the financial statements of the DOD for further detailed information regarding DOD's environmental and disposal liabilities, including cleanup costs.

## Note 17. Benefits Due and Payable

### Benefits Due and Payable as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
Federal Old-Age and Survivors Insurance .....	56.8	53.1
Federal Supplementary Medical Insurance (Medicare Parts B and D) ...	26.2	25.7
Grants to States for Medicaid .....	24.9	26.1
Federal Disability Insurance .....	24.4	23.9
Federal Hospital Insurance (Medicare Part A) .....	20.2	28.6
Supplemental Security Income .....	5.4	5.2
Unemployment Insurance .....	2.1	3.2
All other benefits programs .....	6.2	5.2
Total benefits due and payable .....	<u>166.2</u>	<u>171.0</u>

Benefits due and payable are amounts owed to program recipients or medical service providers as of September 30 that have not been paid. HHS and the SSA administer the majority of the medical service programs and the DOL administers the Unemployment Insurance program. For a description of the programs, see Note 26—Social Insurance and the Unaudited Required Supplementary Information—Social Insurance section.

## Note 18. Insurance and Guarantee Program Liabilities

### Insurance and Guarantee Program Liabilities as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
<b>Insurance and Guarantee Program Liabilities:</b>		
Pension Benefit Guaranty Corporation - Benefit Pension Plans .....	105.6	93.0
Federal Deposit Insurance Corporation Funds .....	26.5	47.4
All other insurance and guarantee programs .....	24.3	21.3
Total insurance and guarantee program liabilities .....	<u>156.4</u>	<u>161.7</u>

PBGC insures pension benefits for participants in covered defined benefit pension plans. As a wholly-owned corporation of the U.S. Government, PBGC's financial activity and balances are included in the consolidated financial statements of the U.S. Government. However, under current law, PBGC's liabilities may be paid only from PBGC's assets and not from the General Fund of the Treasury or assets of the Government in general. As of September 30, 2012, and 2011, PBGC had total liabilities of \$119.2 billion and \$106.7 billion, and its total liabilities exceeded its total assets by \$34.4 billion and \$26.0 billion, respectively. In addition, as discussed in Note 22—Contingencies, PBGC reported reasonably possible contingent losses of about \$321.8 billion and \$250.2 billion as of September 30, 2012, and 2011, respectively. Of the total FDIC amount as of September 30, 2012, and 2011, \$3.6 billion and \$7.2 billion, respectively, represents the recorded contingent liability and loss provision for institutions insured by the Deposit Insurance Fund that are likely to fail. In addition, \$21.2 billion and \$31.5 billion pertain to liabilities due to resolutions of failed or failing institutions and to pending depositor claims as of September 30, 2012, and 2011 respectively. Another \$1.7 billion and \$8.2 billion as of September 30, 2012, and 2011 respectively, pertains to the Temporary Liquidity Guarantee Program, which guarantees certain newly issued debt and certain noninterest-bearing transaction accounts in an effort to counter the system-wide crisis in the nation's financial sector. The remaining amounts represent contingent liabilities for litigation.

Of the \$24.3 billion and \$21.3 billion under all other insurance and guarantee programs as of September 30, 2012, and 2011, respectively, \$20.0 billion and \$10.3 billion, respectively, pertain to the USDA's Federal Crop Insurance Program. The increase in the estimated indemnities is due to the most severe drought in the farm belt since 1988. The Federal Crop Insurance Program is administered by the Federal Crop Insurance Corporation, whose mission is to provide an actuarially sound risk management program to reduce agricultural producers' economic losses due to natural disasters. Also, \$3.4 billion and \$7.4 billion relates to the National Credit Union Administration's Temporary Corporate Credit Union Stabilization Fund as of September 30, 2012, and 2011, respectively. This Program guarantees the timely payment of principal and interest on certain unsecured debt of participating credit unions.

## Note 19. Other Liabilities

<b>Other Liabilities as of September 30, 2012, and 2011</b>	<b>2012</b>	<b>2011</b>
(In billions of dollars)		
<b>Unearned revenue and assets held for others:</b>		
Unearned fees for nuclear waste disposal (DOE) and other unearned revenue .....	56.2	64.4
Assets held on behalf of others .....	<u>74.5</u>	<u>69.8</u>
Subtotal .....	<u>130.7</u>	<u>134.2</u>
<b>Employee-related liabilities:</b>		
Accrued Federal employees wages and benefits .....	40.0	35.2
Selected DOE contractors' and D.C. employees' pension benefits .....	<u>57.0</u>	<u>55.0</u>
Subtotal .....	<u>97.0</u>	<u>90.2</u>
<b>International monetary liabilities and gold certificates:</b>		
Exchange Stabilization Fund .....	59.7	60.3
Gold Certificates (Note 2) .....	<u>11.0</u>	<u>11.0</u>
Subtotal .....	<u>70.7</u>	<u>71.3</u>
<b>Subsidies and grants:</b>		
Farm and other subsidies .....	11.8	12.5
Grant payments due to State and local governments and others .....	<u>16.8</u>	<u>18.1</u>
Subtotal .....	<u>28.6</u>	<u>30.6</u>
<b>Miscellaneous liabilities:</b>		
Legal and other contingencies .....	41.9	38.0
Bonneville Power Administration non-Federal power projects and capital lease liabilities, and disposal liabilities .....	13.2	13.5
Other miscellaneous .....	<u>50.5</u>	<u>49.2</u>
Subtotal .....	<u>105.6</u>	<u>100.7</u>
Total other liabilities .....	<u><u>432.6</u></u>	<u><u>427.0</u></u>

Other liabilities represent liabilities that are not separately identified on the Balance Sheets and are presented on a comparative basis by major category.



## Unearned Revenue and Assets Held for Others

The Government recognizes a liability when it receives money in advance of providing goods and services or assumes custody of money belonging to others. The Government's unearned revenue from fees DOE has collected from utility companies for the future cost of managing the disposal of nuclear waste is about \$32.1 billion and \$30.0 billion as of September 30, 2012, and 2011, respectively. Other unearned revenue includes USPS income for such things as prepaid postage, outstanding money orders, and prepaid P.O. Box rentals. FDIC collected prepaid assessments from the financial institutions to address the Deposit Insurance Fund liquidity needs to pay for projected near-term failures and to ensure that the deposit insurance system remained industry-funded. The prepaid collection was based on maintaining assessment rates at their current levels through the end of 2010 and adopting a uniform three basis point increase in assessment rates effective January 1, 2011. An institution's quarterly risk-based deposit insurance assessment thereafter is offset by the amount prepaid until that amount is exhausted or until June 30, 2013, when any amount remaining would be returned to the institution. The DIF's unearned revenue liability was \$9.2 billion and \$20.4 billion as of September 30, 2012, and 2011, respectively. This decrease is due to the recognition of assessment revenue for the period. Assets held on behalf of others include funds collected in advance and undelivered Defense articles. The Foreign Military Sales program holds \$61.8 billion and \$58.6 billion as of September 30, 2012, and 2011, respectively for articles and services for future delivery to foreign governments.

## Employee-Related Liabilities

This category includes amounts owed to employees at yearend and actuarial liabilities for certain non-Federal employees. Actuarial liabilities for Federal employees and veteran benefits are included in Note 15 and are reported on another line on the balance sheet. The largest liability in the employee-related liabilities category is the amount owed at the end of the fiscal year to Federal employees for wages and benefits (including accrued annual leave). In addition, DOE is liable to certain contractors such as the University of California, which operates the Lawrence Livermore National Laboratory, for contractor employee pension and postretirement benefits, which is about \$31.4 billion and \$30.2 billion as of September 30, 2012, and 2011, respectively. Also, the Government owed about \$10.1 billion and \$9.7 billion as of September 30, 2012, and 2011 respectively, for estimated future pension benefits of the District of Columbia's judges, police, firefighters, and teachers.

## International Monetary Liabilities and Gold Certificates

Consistent with U.S. obligations in the IMF on orderly exchange arrangements and a stable system of exchange rates, the Secretary of the Treasury, with the approval of the President, may use the Exchange Stabilization Fund to deal in gold, foreign exchange, and other instruments of credit and securities.

Gold certificates are issued in nondefinitive or book-entry form to the Federal Reserve banks. The Government's liability incurred by issuing the gold certificates, as reported on the Balance Sheet, is limited to the gold being held by the Department of the Treasury at the standard value established by law. Upon issuance of gold certificates to the Federal Reserve banks, the proceeds from the certificates are deposited into the operating cash of the U.S. Government. All of the Department of the Treasury's certificates issued are payable to the Federal Reserve banks.

## Subsidies and Grants

The Government supports the public good through a wide variety of subsidy and grant programs in such areas as agriculture, medical and scientific research, education, and transportation. USDA programs such as the Conservation Reserve, Tobacco Transition Payment, and Direct and Counter-Cyclical Payment programs account for the majority of the subsidies due, about \$8.1 billion, and \$8.9 billion as of September 30, 2012, and 2011, respectively.

The Government awards hundreds of billions of dollars in grants annually. These include project grants that are competitively awarded for agency-specific projects, such as HHS grants to fund projects to "enhance the independence, productivity, integration and inclusion into the community of people with developmental disabilities." Other grants are formula grants, such as matching grants. Formula grants go to State governments for such things as education and transportation programs. These grants are paid in accordance with distribution formulas that have been provided by law or administrative regulations. Of the total liability reported for grants as of September 30, 2012, and 2011, DOT, Education, and HHS collectively owed their grantees about \$13.0 billion and \$15.0 billion, respectively. Refer to the financial statements and footnotes of the respective agencies for additional information.

### Miscellaneous Liabilities

Some of the more significant liabilities included in this category are for (1) legal and other contingencies (see Note 22—Contingencies), (2) Bonneville Power Administration liability to pay annual budgets of several power projects for its electrical generating capacity, and (3) payables due to derivative contracts and the purchases of securities. In addition, many Federal agencies reported relatively small amounts of miscellaneous liabilities that are not otherwise classified.

## Note 20. Collections and Refunds of Federal Revenue

### Collections of Federal Tax Revenue for the Year Ended September 30, 2012

(In billions of dollars)	Federal Tax Revenue Collections	Tax Year to Which Collections Relate			
		2012	2011	2010	Prior Years
Individual income and tax withholdings .....	2,160.0	1,415.4	699.5	20.7	24.4
Corporation income taxes .....	281.5	197.3	73.1	0.7	10.4
Unemployment taxes .....	66.6	34.8	18.0	13.7	0.1
Excise taxes .....	82.6	62.2	20.2	-	0.2
Estate and gift taxes .....	14.5	0.1	6.8	0.2	7.4
Railroad retirement taxes .....	4.8	3.6	1.2	-	-
Fines, penalties, interest, and other revenue .....	6.3	6.1	0.1	0.1	-
Customs duties .....	30.5	30.5	-	-	-
Subtotal .....	<u>2,646.8</u>	<u>1,750.0</u>	<u>818.9</u>	<u>35.4</u>	<u>42.5</u>
Less: amounts collected for non-Federal entities .....	<u>(0.4)</u>				
Total .....	<u>2,646.4</u>				

Treasury is the Government's principal revenue-collecting agency. Collections of individual income and tax withholdings include FICA/SECA and individual income taxes. These taxes are characterized as non-exchange revenue.

Excise taxes, also characterized as non-exchange revenue, consist of taxes collected for various items, such as airline tickets, gasoline products, distilled spirits and imported liquor, tobacco, firearms, and others.

**Federal Tax Refunds Disbursed for the Year Ended September 30, 2012**

(In billions of dollars)	Refunds Disbursed	Tax Year to Which Refunds Relate			
		2012	2011	2010	Prior Years
Individual income and tax withholdings .....	327.7	0.5	293.5	23.7	10.0
Corporation income taxes .....	44.0	5.1	10.6	7.4	20.9
Unemployment taxes .....	0.1	-	0.1	-	-
Excise taxes .....	1.5	0.5	0.8	0.1	0.1
Estate and gift taxes .....	0.5	-	0.2	0.1	0.2
Customs duties .....	1.9	1.9	-	-	-
Total.....	<u>375.7</u>	<u>8.0</u>	<u>305.2</u>	<u>31.3</u>	<u>31.2</u>

**Reconciliation of Revenue to Tax Collections for the Year Ended September 30, 2012, and 2011**

(In billions of dollars)	2012	2011
Consolidated revenue per the Statements of Operations and Changes in Net Position .....	2,518.2	2,363.8
Tax refunds .....	375.7	417.6
First-time Homebuyers Tax Credit .....	-	(2.2)
Making work pay credit .....	(0.3)	(13.9)
Earned income tax credit and child tax credit imputed revenue .....	(77.0)	(78.3)
Other tax credits and accrual adjustments .....	(15.8)	(13.9)
Federal Reserve earnings.....	(82.0)	(82.5)
Nontax-related fines and penalties reported by agencies .....	(52.7)	(49.5)
Nontax-related earned revenue .....	(19.7)	(16.2)
Collections of Federal tax revenue .....	<u>2,646.4</u>	<u>2,524.9</u>

Consolidated revenue in the Statements of Operations and Changes in Net Position is presented on a modified cash basis, is net of tax refunds, and includes other nontax related revenue. Earned Income Tax Credit and Child Tax Credit, Other tax credits amounts (unaudited), Making work pay credit, and First-time Homebuyer Credit are included in gross cost in the Statements of Net Cost as a component of Treasury Collections of Federal tax revenue. The table above reconciles total revenue to Federal tax collections.

### Collections of Federal Tax Revenue for the Year Ended September 30, 2011

(In billions of dollars)	Federal Tax Revenue Collections	Tax Year to Which Collections Relate			
		2011	2010	2009	Prior Years
Individual income and tax withholdings .....	2,102.0	1,357.0	703.9	19.0	22.1
Corporation income taxes .....	242.8	165.7	62.6	1.9	12.6
Unemployment taxes .....	56.2	30.4	14.3	11.4	0.1
Excise taxes .....	75.7	56.3	19.0	0.1	0.3
Estate and gift taxes .....	9.1	-	6.4	0.7	2.0
Railroad retirement taxes .....	4.7	3.5	1.2	-	-
Fines, penalties, interest, and other revenue .....	5.4	5.2	0.1	0.1	-
Customs duties .....	29.9	29.9	-	-	-
Subtotal .....	<u>2,525.8</u>	<u>1,648.0</u>	<u>807.5</u>	<u>33.2</u>	<u>37.1</u>
Less: amounts collected for non-Federal entities .....	<u>(0.9)</u>				
Total .....	<u><u>2,524.9</u></u>				

### Federal Tax Refunds Disbursed for the Year Ended September 30, 2011

(In billions of dollars)	Refunds Disbursed	Tax Year to Which Refunds Relate			
		2011	2010	2009	Prior Years
Individual income and tax withholdings .....	344.4	1.1	302.8	26.5	14.0
Corporation income taxes .....	67.8	6.3	16.6	6.5	38.4
Unemployment taxes .....	0.1	-	0.1	-	-
Excise taxes .....	2.2	0.8	1.0	0.2	0.2
Estate and gift taxes .....	1.8	-	-	0.4	1.4
Customs duties .....	1.3	0.6	0.3	0.1	0.3
Total .....	<u>417.6</u>	<u>8.8</u>	<u>320.8</u>	<u>33.7</u>	<u>54.3</u>

## Note 21. Prior-Period Adjustments

### Prior-Period Adjustments for the Year Ended September 30, 2012, and 2011

(In billions of dollars)	Changes to Net Position	
	2012	2011
<b>Prior-period adjustments</b>		
Department of Homeland Security.....	0.7	-
Total prior-period adjustments.....	0.7	-

For fiscal year 2012, DHS applied a change in accounting principles that changed activity previously classified as General PP&E to operating materials and supplies. This change by DHS ultimately resulted in an adjustment to beginning of the year cumulative results of operations totaling \$711.0 million on their Statement of Changes in Net Position. Please refer to DHS audited financial statements for detailed information pertaining to their change in accounting principles.

For fiscal years 2012 and 2011, as discussed in Note 1.V—Reclassifications, one fund in each year that was previously reported as an earmarked fund was reclassified to non-earmarked funds and was recorded as a prior period adjustment. As shown in the Statement of Changes in Net Position, this reclassification had no effect on the total net position.

## Note 22. Contingencies

### Financial Treatment of Loss Contingencies

Loss contingencies that are assessed to be at least reasonably possible are disclosed in this note. Loss contingencies involve situations where there is an uncertainty of a possible loss. The reporting of loss contingencies depends on the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability. Terms used to assess the range for the likelihood of loss are probable, reasonably possible, and remote. Loss contingencies that are assessed as probable and measurable are accrued in the financial statements. Loss contingencies that are assessed as remote are not reported in the financial statements, nor disclosed in the notes. All other material loss contingencies are disclosed in this note. The following table provides criteria for how Federal agencies are to account for loss contingencies, based on the likelihood of the loss and measurability.<sup>1</sup>

Likelihood of future outflow or other sacrifice of resources.	Loss amount can be reasonably measured.	Loss range can be reasonably measured.	Loss amount or range cannot be reasonably measured.
<b>Probable</b> Future confirming event(s) are more likely to occur than not. <sup>2</sup>	Accrue the liability. Report on Balance Sheet and Statement of Net Cost.	Accrue liability of the best estimate or minimum amount in loss range if there is no best estimate, and disclose nature of contingency and range of estimated liability.	Disclose nature of contingency and include a statement that an estimate cannot be made.
<b>Reasonably possible</b> Possibility of future confirming event(s) occurring is more than remote and less than likely.	Disclose nature of contingency and estimated loss amount.	Disclose nature of contingency and estimated loss range.	Disclose nature of contingency and include a statement that an estimate cannot be made.
<b>Remote</b> Possibility of future event(s) occurring is slight.	No disclosure	No disclosure	No disclosure

<sup>1</sup> In addition, a third condition must be met to be a loss contingency: a past event or an exchange transaction must occur.

<sup>2</sup> For loss contingencies related to litigation, probable is defined as the future confirming event or events are more likely than not to occur, with the exception of pending or threatened litigation and unasserted claims. For the pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur.

The Government is subject to loss contingencies that include insurance and litigation cases. These loss contingencies arise in the normal course of operations and their ultimate disposition is unknown. Based on information currently available, however, it is management's opinion that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the financial statements, except for the insurance and litigation described in the following sections:

### **Insurance Contingencies**

At the time an insurance policy is issued, a contingency arises. The contingency is the risk of loss assumed by the insurer, that is, the risk of loss from events that may occur during the term of the policy. The Government has insurance contingencies that are reasonably possible in the amount of \$329.0 billion as of September 30, 2012, and \$267.0 billion as of September 30, 2011. The major programs are identified below:

- PBGC reported \$321.8 billion and \$250.2 billion as of September 30, 2012, and 2011, respectively, for the estimated aggregate unfunded vested benefits exposure to the PBGC for private-sector single-employer and multiemployer defined benefit pension plans that are classified as a reasonably possible exposure to loss.
- FDIC reported \$6.9 billion and \$16.5 billion as of September 30, 2012, and 2011, respectively, for identified additional risk in the financial services industry that could result in additional loss to the Deposit Insurance Fund should potentially vulnerable insured institutions ultimately fail. Actual losses, if any, will largely depend on future economic and market conditions.

### **Deposit Insurance**

Deposit insurance covers all types of deposit accounts such as checking, NOW and savings accounts, money market deposit accounts, and certificates of deposit received at an insured bank, savings association, or credit union. The insurance covers the balance of each depositor's account and shares, dollar-for-dollar, up to the insurance limit, including principal and any accrued interest through the date of the insured financial institution's closing. As a result, the Government has the following exposure from Federally-insured financial institutions:

- FDIC has estimated insured deposits of \$7,250.7 billion as of September 30, 2012, and \$6,777.0 billion as of September 30, 2011, for the Deposit Insurance Fund.
- National Credit Union Administration (NCUA) has estimated insured shares of \$834.3 billion as of September 30, 2012, and \$782.4 billion as of September 30, 2011, for the National Credit Union Share Insurance Fund.

## Legal Contingencies

Legal contingencies as of September 30, 2012, and 2011, are summarized in the table below:

(In billions of dollars)	2012			2011		
	Accrued Liabilities <sup>1</sup>	Estimated Range of Loss for Certain Cases <sup>2</sup>		Accrued Liabilities <sup>1</sup>	Estimated Range of Loss for Certain Cases <sup>2</sup>	
		Lower End	Upper End		Lower End	Upper End
Legal contingencies						
Probable.....	9.9	9.9	11.1	9.2	9.0	9.7
Reasonably possible .....		12.8	15.2		12.4	14.6

<sup>1</sup> Accrued liabilities are recorded and presented in the related line items of the balance sheet.  
<sup>2</sup> Does not reflect the total range of loss; many cases assessed as reasonably possible of an unfavorable outcome did not include estimated losses that could be determined.

The Government is party to various administrative claims and legal actions brought against it, some of which may ultimately result in settlements or decisions against the Government.

Management and legal counsel have determined that it is “probable” that some of these actions will result in a loss to the Government and the loss amounts are reasonably measurable. The estimated liabilities for these cases are \$9.9 billion and \$9.2 billion as of September 30, 2012, and 2011, respectively, and are included in “Other Liabilities” on the Balance Sheet. For example, DOI is subject to various claims and contingencies related to lawsuits. For cases in which payment has been deemed probable and for which the amount of potential liability has been estimated, about \$4.4 billion and \$4.7 billion has been accrued in the financial statements as of September 30, 2012, and 2011, respectively. The Cobell vs. Salazar lawsuit was brought against DOI and Treasury on behalf of 490,000 individual Indian trust beneficiaries for an historical accounting of their trust accounts and reform of trust management systems. On December 7, 2009, the parties announced that a \$3.4 billion settlement had been reached. On December 8, 2010, the President signed into law H.R. 4783, the Claims Resolution Act of 2010, which authorized and funded the settlement. The Government made the two payments provided for in the settlement agreement in November 2012—approximately \$1.5 billion to an account at a financial institution approved by the court, to be further distributed to class members by plaintiff’s claim administrator and a \$1.9 billion payment to a Treasury account to be used by the Department of the Interior to purchase highly fractioned interests in Indian trust lands. Additional settlements were reached with 41 tribes totaling more than \$1.0 billion, all of which were paid in late fiscal year 2012.

There are also administrative claims and legal actions pending where adverse decisions are considered by management and legal counsel as “reasonably possible” with an estimate of potential loss or a range of potential loss. The estimated potential losses for such claims and actions range from \$12.8 billion to \$15.2 billion as of September 30, 2012, and from \$12.4 billion to \$14.6 billion as of September 30, 2011.



Numerous litigation cases are pending where the outcome is uncertain or it is reasonably possible that a loss has been incurred and where estimates cannot be made. There are other litigation cases where the plaintiffs have not made claims for specific dollar amounts, but the claimed amounts may be significant. The ultimate resolution of these legal actions for which the potential loss could not be determined may materially affect the U.S. Government’s financial position or operating results. Examples of specific cases are summarized below:

- Tribal Trust Fund Cases - Numerous cases have been filed in U.S. District Court in which Native American Tribes seek a declaration that the United States has not provided the tribes with a full and complete accounting of their trust funds, and seek an order requiring the Government to provide such an accounting. It is not possible at this time to determine the likelihood of an unfavorable outcome or an estimate of the amount or range of any potential loss.
- Various parties filed administrative claims and lawsuits against the U.S. Army Corps of Engineers as a result of Hurricane Katrina in 2005. Most of the Hurricane Katrina tort actions that have been filed are consolidated before a single judge sitting in the Eastern District of Louisiana. The court has classified the individual cases that have been consolidated into seven categories: Levee, MRGO, Insurance, Responder, Dredging Limitations, St. Rita Nursing Home, and Barge. Approximately 565,000 administrative claims related to the allegations in this consolidated action have been filed.

**Environmental and Disposal Contingencies**

Environmental and disposal contingencies as of September 30, 2012, and 2011, are summarized in the table below:

(In billions of dollars)	Accrued Liabilities <sup>1</sup>	2012 Estimated Range of Loss for Certain Cases <sup>2</sup>		Accrued Liabilities <sup>1</sup>	2011 Estimated Range of Loss for Certain Cases <sup>2</sup>	
		Lower End	Upper End		Lower End	Upper End
Environmental and disposal contingencies						
Probable .....	20.7	20.7	21.0	20.0	20.0	20.2
Reasonably possible .....		0.6	0.6		0.2	0.2

<sup>1</sup> Accrued liabilities are recorded and presented in the related line items of the Balance Sheet.  
<sup>2</sup> Does not reflect the total range of loss; many cases assessed as reasonably possible of an unfavorable outcome did not include estimated losses that could be determined.

The Government is subject to loss contingencies for a variety of environmental cleanup costs for the storage and disposal of hazardous material and the operations and closures of facilities at which environmental contamination may be present.

Management and legal counsel have determined that it is “probable” that some of these actions will result in a loss to the Government and the loss amounts are reasonably measurable. The estimated liabilities for these cases are \$20.7 billion and \$20.0 billion as of September 30, 2012, and 2011, respectively, and are included in “Other Liabilities” on the Balance Sheet. DOE is also subject to Spent Nuclear Fuel litigation for damages suffered by all utilities as a result of the delay in beginning disposal of spent nuclear fuel and also damages for alleged exposures to radioactive and/or toxic substances. Significant claims for partial breach of contract and a large number of class action and/or multiple plaintiff tort suits have been filed with estimated liability amounts of \$19.7 billion and \$19.1 billion as of September 30, 2012, and 2011, respectively.

### **Other Contingencies**

DOT and HHS reported the following other contingencies:

- The Federal Highway Administration (FHWA) reimburses states for construction costs on projects related to the Federal Highway System of roads. FHWA has pre-authorized \$44.3 billion and \$41.4 billion to the states to establish budgets for its construction projects for fiscal years ending September 30, 2012, and 2011, respectively. Congress has not provided appropriations for these projects and no liability is accrued in the consolidated financial statements.
- Contingent liabilities have been accrued as a result of Medicaid audit and program disallowances that are currently being appealed by the States. The Medicaid amounts are \$3.9 billion and \$3.0 billion for fiscal years ending September 30, 2012, and 2011, respectively.

### **Treaties**

The U.S. Government is a party to major treaties and other international agreements. These treaties and other international agreements address various issues including, but not limited to, trade, commerce, security, and arms that may involve financial obligations or give rise to possible exposure to losses. A comprehensive analysis to determine any such financial obligations or possible exposure to loss and their related effect on the consolidated financial statements of the U.S. Government has not yet been performed.

## Note 23. Commitments

### Long-Term Operating Leases as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
General Services Administration.....	29.5	26.7
U.S. Postal Service .....	7.0	7.3
Department of State .....	1.6	1.4
Department of Defense.....	1.6	1.2
Department of Health and Human Services ..	1.2	1.5
Department of Agriculture .....	0.8	0.8
Department of the Treasury .....	0.7	0.7
Other operating leases.....	4.1	4.3
Total long-term operating leases.....	<u>46.5</u>	<u>43.9</u>

The Government has entered into contractual commitments that require future use of financial resources. It has significant amounts of long-term lease obligations and undelivered orders. Undelivered orders represent the value of goods and services ordered that have not yet been received.

The Government has other commitments that may require future use of financial resources. For example, the Government has callable subscriptions in certain Multilateral Development Banks (MDBs), which are international financial institutions that finance economic and social development projects in developing countries. Callable capital stock shares in the MDBs serve as a supplemental pool of resources that may be called, and converted into ordinary paid in shares, if the MDB cannot otherwise meet certain obligations through its other available resources. MDBs are able to use callable capital as backing to obtain very favorable financing terms when borrowing from world capital markets. To date, there has never been a call on this capital for any of the major MDBs and none is anticipated.

### Undelivered Orders and Other Commitments as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
<b>Undelivered Orders:</b>		
Department of Education .....	230.8	229.2
Department of Defense .....	211.7	315.9
Department of the Treasury .....	186.9	207.1
EOP Foreign Military Sales Program .....	163.5	121.4
Department of Transportation .....	104.0	104.7
Department of Health and Human Services .....	91.8	90.3
Department of Housing and Urban Development ...	49.7	56.9
Department of Agriculture .....	49.1	51.7
Department of Homeland Security .....	33.3	36.3
Department of Energy .....	29.1	45.7
Department of State .....	20.8	20.9
Export-Import Bank of the United States .....	17.3	9.7
Agency for International Development .....	16.3	15.6
National Science Foundation .....	11.4	11.6
Department of Labor .....	9.9	9.6
Department of Veterans Affairs .....	9.7	8.7
All other agencies .....	57.3	64.6
Total undelivered orders: .....	<u>1,292.6</u>	<u>1,399.9</u>
<b>Other Commitments:</b>		
Senior GSE Preferred Stock Purchase Agreement ..	273.2	-
Callable capital subscriptions for multilateral development banks.....	82.3	72.0
Fuel purchase obligations .....	7.1	8.5
Agriculture direct loans and guarantees.....	6.0	5.9
Power purchase obligations.....	4.3	5.1
Long-term satellite and systems.....	4.2	3.2
Conservation Reserve Program.....	1.8	1.8
All other commitments.....	5.7	6.8
Total other commitments .....	<u>384.6</u>	<u>103.3</u>

## Other Commitments and Risks

### Commitments to GSE

The SPSPA agreements between Treasury and each GSE, which have no expiration date, provide for Treasury to disburse funds to the GSEs if, at the end of any quarter, the FHFA determines that the liabilities exceed its assets. At September 30, 2012, Treasury recorded a contingent liability of \$9.0 billion with a projected maximum remaining potential commitment to the GSEs of \$282.3 billion. The recorded contingent liability of \$316.2 billion at September 30, 2011, constituted the maximum commitment payable at the end of that year. Therefore, the SPSPA commitments are \$273.2 billion and \$0.0 billion as of September 30, 2012, and 2011, respectively. Such accruals are adjusted as new information develops or circumstances change. Refer to Note 11—Investments in and Liabilities to Government-Sponsored Enterprises for a full description of the SPSPA agreements and related contingent liability.

### Terrorism Risk Insurance Program

The U. S. Government has entered into agreements that could potentially require claims on Government resources in the future. For example, The Terrorism Risk Insurance Act of 2002 (TRIA or the Act) was signed into law on November 26, 2002. This law was enacted to address market disruptions resulting from terrorist attacks on September 11, 2001. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 (Reauthorization Act) was enacted extending the Program through December 31, 2014. The Act helps to ensure available and affordable commercial property and casualty insurance for terrorism risk, and simultaneously allows private markets to stabilize. The Terrorism Risk Insurance Program is activated upon the certification of an “act of terrorism” by the Secretary of the Treasury in concurrence with the Secretary of State and the Attorney General. If a certified act of terrorism occurs, insurers may be eligible to receive reimbursement from the Government for insured losses above a designated deductible amount. Insured losses above this amount will be shared between insurance companies and the Government. The Act also gives Treasury authority to recoup Federal payments made under the Program through policyholder surcharges under certain circumstances and contains provisions designed to manage litigation arising from or relating to a certified act of terrorism. There were no claims under TRIA as of September 30, 2012, or September 30, 2011.

## Note 24. Earmarked Funds

### Earmarked Funds as of September 30, 2012 <sup>1</sup>

(In billions of dollars)	Federal Old-Age and Survivors Insurance Trust Fund	Military Retirement Fund	Civil Service Retirement and Disability Fund	Medicare- Eligible Retiree Health Care Fund (MERHCF)	Federal Hospital Insurance Trust Fund (Medicare Part A)	Civil Service Health Benefits Program Trust Funds
<b>Assets:</b>						
Cash and other monetary assets.....	-	-	-	-	-	-
Fund balance with Treasury .....	(0.5)	-	-	0.2	1.5	1.2
Investments in U.S. Treasury securities, net of unamortized premiums/discounts .....	2,586.7	424.2	826.6	201.4	228.3	66.8
Other Federal assets.....	25.0	3.7	9.1	2.0	27.5	12.3
Non-Federal assets.....	2.0	0.1	0.2	1.0	1.5	0.9
Total assets.....	<u>2,613.2</u>	<u>428.0</u>	<u>835.9</u>	<u>204.6</u>	<u>258.8</u>	<u>81.2</u>
<b>Liabilities:</b>						
Liabilities due and payable to beneficiaries .....	56.9	4.0	5.9	0.6	20.2	4.4
Other Federal liabilities.....	4.7	0.1	0.1	0.1	25.7	0.3
Other non-Federal liabilities .....	-	1,477.9	1,679.0	533.3	0.6	316.5
Total liabilities.....	61.6	1,482.0	1,685.0	534.0	46.5	321.2
Total net position .....	<u>2,551.6</u>	<u>(1,054.0)</u>	<u>(849.1)</u>	<u>(329.4)</u>	<u>212.3</u>	<u>(240.0)</u>
Total liabilities and net position .....	<u>2,613.2</u>	<u>428.0</u>	<u>835.9</u>	<u>204.6</u>	<u>258.8</u>	<u>81.2</u>
<b>Change in net position:</b>						
Beginning net position.....	2,462.1	(989.1)	(724.2)	(346.3)	226.8	(267.8)
Prior-period adjustment.....	-	-	-	-	-	-
Beginning net position, adjusted ....	2,462.1	(989.1)	(724.2)	(346.3)	226.8	(267.8)
Investment revenue.....	104.0	12.5	34.0	6.3	10.9	1.9
Individual income taxes.....	500.1	-	-	-	204.8	-
Unemployment and excise taxes...	-	-	-	-	-	-
Other taxes and receipts .....	0.1	-	-	-	0.6	-
Miscellaneous earned revenues ....	-	-	-	-	-	-
Other changes in fund balance (e.g., appropriations, transfers).....	116.7	92.0	33.0	17.9	19.7	10.7
Non-program expenses.....	-	-	-	-	-	-
Program net cost.....	631.4	169.4	191.9	7.3	250.5	(15.2)
Ending net position.....	<u>2,551.6</u>	<u>(1,054.0)</u>	<u>(849.1)</u>	<u>(329.4)</u>	<u>212.3</u>	<u>(240.0)</u>

<sup>1</sup> By law, certain expenses (costs), revenues, and other financing sources related to the administration of the above funds are not charged to the funds and are therefore financed and/or credited to other sources.

**Earmarked Funds as of September 30, 2012 <sup>1</sup>**

(In billions of dollars)	Federal Disability Insurance Trust Fund	Federal Supplementary Medical Insurance Trust Fund (Medicare Parts B and D)	Exchange Stabilization Fund	All Other Earmarked Funds	Intra- Earmarked Fund Eliminations	Total Earmarked Funds
<b>Assets:</b>						
Cash and other monetary assets .....	-	-	65.8	0.4	-	66.2
Fund balance with Treasury ..	(0.5)	21.8	-	102.2	-	125.9
Investments in U.S. Treasury securities, net of unamortized premiums/discounts .....	132.3	69.3	22.7	198.1	-	4,756.4
Other Federal assets .....	1.6	30.8	0.1	23.5	(60.8)	74.8
Non-Federal assets .....	3.8	7.8	15.3	97.1	-	129.7
Total assets .....	<u>137.2</u>	<u>129.7</u>	<u>103.9</u>	<u>421.3</u>	<u>(60.8)</u>	<u>5,153.0</u>
<b>Liabilities:</b>						
Liabilities due and payable to beneficiaries .....	24.6	26.2	-	4.2	-	147.0
Other Federal liabilities .....	1.3	31.4	-	87.1	(60.8)	90.0
Other non-Federal liabilities ...	-	2.0	59.7	181.7	-	4,250.7
Total liabilities .....	<u>25.9</u>	<u>59.6</u>	<u>59.7</u>	<u>273.0</u>	<u>(60.8)</u>	<u>4,487.7</u>
Total net position .....	<u>111.3</u>	<u>70.1</u>	<u>44.2</u>	<u>148.3</u>	<u>-</u>	<u>665.3</u>
Total liabilities and net position .....	<u>137.2</u>	<u>129.7</u>	<u>103.9</u>	<u>421.3</u>	<u>(60.8)</u>	<u>5,153.0</u>
<b>Change in net position:</b>						
Beginning net position .....	141.9	66.4	44.8	133.6	-	748.2
Prior-period adjustment .....	-	-	-	(0.6)	-	(0.6)
Beginning net position, adjusted .....	141.9	66.4	44.8	133.0	-	747.6
Investment revenue .....	6.8	2.9	-	6.0	-	185.3
Individual income taxes .....	85.0	-	-	-	-	789.9
Unemployment and excise taxes .....	-	-	-	123.0	-	123.0
Other taxes and receipts .....	-	2.8	-	28.2	(0.8)	30.9
Miscellaneous earned revenues .....	-	-	-	6.2	-	6.2
Other changes in fund balance (e.g., appropriations, transfers) ..	13.3	225.2	-	48.0	-	576.5
Non-program expenses .....	-	-	-	5.1	-	5.1
Program net cost .....	<u>135.7</u>	<u>227.2</u>	<u>0.6</u>	<u>191.0</u>	<u>(0.8)</u>	<u>1,789.0</u>
Ending net position .....	<u>111.3</u>	<u>70.1</u>	<u>44.2</u>	<u>148.3</u>	<u>-</u>	<u>665.3</u>

<sup>1</sup> By law, certain expenses (costs), revenues, and other financing sources related to the administration of the above funds are not charged to the funds and are therefore financed and/or credited to other sources.

**Earmarked Funds as of September 30, 2011 <sup>1</sup>**

(In billions of dollars)	Federal Old-Age and Survivors Insurance Trust Fund	Military Retirement Fund	Civil Service Retirement and Disability Fund	Medicare- Eligible Retiree Health Care Fund (MERHCF)	Federal Hospital Insurance Trust Fund (Medicare Part A)	Civil Service Health Benefits Program Trust Funds
<b>Assets:</b>						
Cash and other monetary assets .....	-	-	-	-	-	-
Fund balance with Treasury .....	(0.6)	0.4	-	0.2	0.4	1.3
Investments in U.S. Treasury Securities, net of unamortized premiums/discounts .....	2,492.5	368.2	803.8	185.9	245.9	62.9
Other Federal assets .....	26.2	3.6	10.7	1.9	37.0	1.1
Non-Federal assets .....	1.9	-	0.3	0.5	6.3	1.0
<b>Total assets .....</b>	<b>2,520.0</b>	<b>372.2</b>	<b>814.8</b>	<b>188.5</b>	<b>289.6</b>	<b>66.3</b>
<b>Liabilities and net position:</b>						
Liabilities due and payable to beneficiaries .....	53.2	0.3	5.5	0.7	28.6	4.3
Other Federal liabilities .....	4.7	-	0.1	0.1	33.9	0.3
Other non-Federal liabilities .....	-	1,361.0	1,533.4	534.0	0.3	329.5
<b>Total liabilities .....</b>	<b>57.9</b>	<b>1,361.3</b>	<b>1,539.0</b>	<b>534.8</b>	<b>62.8</b>	<b>334.1</b>
<b>Total net position .....</b>	<b>2,462.1</b>	<b>(989.1)</b>	<b>(724.2)</b>	<b>(346.3)</b>	<b>226.8</b>	<b>(267.8)</b>
<b>Total liabilities and net position .....</b>	<b>2,520.0</b>	<b>372.2</b>	<b>814.8</b>	<b>188.5</b>	<b>289.6</b>	<b>66.3</b>
<b>Change in net position:</b>						
Beginning net position .....	2,370.7	(941.0)	(765.6)	(406.9)	261.8	(284.3)
Prior-period adjustment .....	-	-	-	-	-	-
Beginning net position, adjusted .....	2,370.7	(941.0)	(765.6)	(406.9)	261.8	(284.3)
Investment revenue .....	106.9	18.0	35.4	9.2	12.4	1.9
Individual income taxes .....	496.5	-	-	-	192.1	-
Unemployment and excise taxes .....	-	-	-	-	-	-
Other taxes and receipts .....	-	-	-	-	0.6	-
Miscellaneous earned revenue .....	-	-	-	-	-	-
Other changes in fund balance (e.g., appropriations, transfers) .....	81.7	87.3	31.3	21.1	16.2	10.3
Non-program expenses .....	-	-	-	-	-	-
Program net cost .....	593.7	153.4	25.3	(30.3)	256.3	(4.3)
<b>Ending net position .....</b>	<b>2,462.1</b>	<b>(989.1)</b>	<b>(724.2)</b>	<b>(346.3)</b>	<b>226.8</b>	<b>(267.8)</b>

<sup>1</sup> By law, certain expenses (costs), revenues, and other financing sources related to the administration of the above funds are not charged to the funds and are therefore financed and/or credited to other sources.



**Earmarked Funds as of September 30, 2011 <sup>1</sup>**

(In billions of dollars)	Federal Disability Insurance Trust Fund	Federal Supplementary Medical Insurance Trust Fund (Medicare Parts B and D)	Exchange Stabilization Fund	All Other Earmarked Funds	Intra- Earmarked Fund Eliminations	Total Earmarked Funds
<b>Assets:</b>						
Cash and other monetary assets .....	-	-	66.7	0.4	-	67.1
Fund balance with Treasury .....	(0.4)	5.7	-	103.6	-	110.6
Investments in U.S. Treasury Securities, net of unamortized premiums/discounts.....	162.0	70.4	22.7	193.4	-	4,607.7
Other Federal assets .....	1.8	29.3	0.1	23.0	(67.9)	66.8
Non-Federal assets .....	3.8	17.5	15.7	88.2	-	135.2
Total assets .....	<u>167.2</u>	<u>122.9</u>	<u>105.2</u>	<u>408.6</u>	<u>(67.9)</u>	<u>4,987.4</u>
<b>Liabilities and net position:</b>						
Liabilities due and payable to beneficiaries .....	24.2	25.7	-	5.2	-	147.7
Other Federal liabilities.....	1.1	30.4	-	96.7	(67.9)	99.4
Other non-Federal liabilities ...	-	0.4	60.4	173.1	-	3,992.1
Total liabilities .....	25.3	56.5	60.4	275.0	(67.9)	4,239.2
Total net position .....	<u>141.9</u>	<u>66.4</u>	<u>44.8</u>	<u>133.6</u>	<u>-</u>	<u>748.2</u>
Total liabilities and net position .....	<u>167.2</u>	<u>122.9</u>	<u>105.2</u>	<u>408.6</u>	<u>(67.9)</u>	<u>4,987.4</u>
<b>Change in net position:</b>						
Beginning net position .....	166.7	53.5	43.8	148.2	-	646.9
Prior-period adjustment .....	-	-	-	2.0	-	2.0
Beginning net position, adjusted .....	166.7	53.5	43.8	150.2	-	648.9
Investment revenue .....	8.2	3.2	-	6.8	-	202.0
Individual income taxes .....	84.3	-	-	-	-	772.9
Unemployment and excise taxes .....	-	-	-	108.3	-	108.3
Other taxes and receipts .....	-	1.9	-	19.1	(0.7)	20.9
Miscellaneous earned revenue.....	-	-	-	4.9	-	4.9
Other changes in fund balance (e.g., appropriations, transfers)..	10.3	225.6	-	56.7	-	540.5
Non-program expenses .....	-	-	-	4.8	-	4.8
Program net cost .....	<u>127.6</u>	<u>217.8</u>	<u>(1.0)</u>	<u>207.6</u>	<u>(0.7)</u>	<u>1,545.4</u>
Ending net position .....	<u>141.9</u>	<u>66.4</u>	<u>44.8</u>	<u>133.6</u>	<u>-</u>	<u>748.2</u>

<sup>1</sup> By law, certain expenses (costs), revenues, and other financing sources related to the administration of the above funds are not charged to the funds and are therefore financed and/or credited to other sources.

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits, or purposes and must be accounted for separately from the Government's general revenues. Earmarked funds generally include trust funds, public enterprise revolving funds (not including credit reform financing funds), and special funds.

In the Federal budget, the term "trust fund" means only that the law requires a particular fund be accounted for separately, used only for a specified purpose, and designated as a trust fund. A change in law may change the future receipts and the terms under which the fund's resources are spent. In the private sector, trust fund refers to funds of one party held and managed by a second party (the trustee) in a fiduciary capacity. The activity of earmarked funds differs from fiduciary activities primarily in that earmarked fund assets are Government-owned.

Public enterprise revolving funds include expenditure accounts authorized by law to be credited with offsetting collections, mostly from the public, that are generated by and earmarked to finance a continuing cycle of business-type operations. Some of the financing for these funds may be from appropriations.

Special funds are Federal funds earmarked by law for a specific purpose. Special funds include the special fund receipt account and the special fund expenditure account.

The tables above depict major earmarked funds chosen based on their significant financial activity and importance to taxpayers. All other Government earmarked funds not shown separately are aggregated as "all other."

Total assets represent the unexpended balance from all sources of receipts and amounts due to the earmarked funds, regardless of source, including related Governmental transactions. These are transactions between two different entities within the Government (for example, monies received by one entity of the Government from another entity of the Government).

The intragovernmental assets are comprised of fund balances with Treasury, investments in Treasury securities—including unamortized amounts, and other assets that include the related accrued interest receivable on Federal investments. These amounts were eliminated in preparing the principal financial statements.

The non-Federal assets represent only the activity with individuals and organizations outside of the Government.

Most of the earmarked fund assets are invested in intragovernmental debt holdings. The Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to Federal agencies as evidence of its receipts. Treasury securities are an asset to the Federal agencies and a liability to the U.S. Treasury and, therefore, they do not represent an asset or a liability in the FR. These securities require redemption if a fund's disbursements exceeds its receipts. Redeeming these securities will increase the Government's financing needs and require more borrowing from the public (or less repayment of debt), or will result in higher taxes than otherwise would have been needed, or less spending on other programs than otherwise would have occurred, or some combination thereof. See Note 14—Federal Debt Securities Held by the Public and Accrued Interest for further information related to the investments in Federal debt securities.

Depicted below is a description of the major earmarked funds shown in the above tables, which also includes the names of the Government agencies that administer each particular fund. For detailed information regarding these earmarked funds, please refer to the financial statements of the corresponding administering agencies. For information on the benefits due and payable liability associated with certain earmarked funds, see Note 17—Benefits Due and Payable.

## Federal Old-Age and Survivors Insurance Trust Fund

The Federal Old-Age and Survivors Insurance Trust Fund, administered by the SSA, provides a basic annuity to workers to protect them from loss of income at retirement and provide a guaranteed income to survivors in the event of the death of a family's primary wage earner.

Payroll and self-employment taxes primarily fund the Federal Old-Age and Survivors Insurance Trust Fund. Interest earnings on Treasury securities, Federal agencies' payments for the Social Security benefits earned by military and Federal civilian employees, and Treasury payments for a portion of income taxes collected on Social Security benefits provide the fund with additional income. The law establishing the Federal Old-Age and Survivors Insurance Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 401.

## **Military Retirement Fund**

The Military Retirement Fund, administered by DOD, provides retirement benefits for Army, Navy, Marine Corps, and Air Force personnel and their survivors. The fund is financed by DOD contributions, appropriations, and interest earnings on Treasury securities. The laws establishing the Military Retirement Fund and authorizing the depositing of amounts to the credit of the trust fund are set forth in 10 U.S.C. § 1461-1467.

## **Civil Service Retirement and Disability Fund**

The CSRDF covers two Federal civilian retirement systems: the CSRS—for employees hired before 1984, and the FERS—for employees hired after 1983. OPM administers the CSRS and the FERS systems. The laws establishing the CSRDF and authorizing the depositing of amounts to the credit of the trust fund are set forth in 5 U.S.C. §§ 8331-8348. Funding sources include:

- Federal civilian employees' contributions.
- Agencies' contributions on behalf of employees.
- Appropriations.
- Interest earnings on Treasury securities.

## **Medicare-Eligible Retiree Health Care Fund**

The Department of Defense Medicare-Eligible Retiree Health Care Fund, administered by the Secretary of the Treasury and established by 10 U.S.C. § 1111, finances and pays the liabilities under the DOD retiree health care programs for military retirees, their dependents and survivors who are Medicare-Eligible. Such beneficiaries include qualifying members, former members, and dependents of the Uniformed Services. The assets of the fund are comprised of any amounts appropriated to the trust fund, payments to the fund authorized by 10 U.S.C. § 1116, and interest earned on investments authorized by 10 U.S.C. § 1117.

## **Federal Hospital Insurance Trust Fund (Medicare Part A)**

The Federal Hospital Insurance Trust Fund, administered by HHS, finances the Hospital Insurance Program (Medicare Part A). This program funds the cost of inpatient hospital and related care for individuals age 65 or older who meet certain insured status requirements, and eligible disabled people.

The Federal Hospital Insurance Trust Fund is financed primarily by payroll taxes, including those paid by Federal agencies. It also receives income from interest earnings on Treasury securities and a portion of income taxes collected on Social Security benefits. The law establishing the Federal Hospital Insurance Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 1395i.

## **Civil Service Health Benefits Program Trust Funds**

The Civil Service Health Benefits Program (HBP) provides health benefits to Federal employees and dependents as well as to Federal retirees, including USPS retirees, and survivor annuitants. The program is primarily operated through three revolving trust funds. The HBP administers a wide variety of health and wellness plans including Fee-For-Service and HMO plans. Retired employees can choose to continue coverage upon separation from the Government. OPM administers the HBP.

The law establishing the first HBP trust fund, the FEHB Fund, and authorizing the depositing of amounts to the credit of the trust fund is set forth in 5 U.S.C. § 8909. The FEHB fund is funded on a “pay-as-you-go” basis and funding sources include:

- Federal civilian employees’ contributions.
- Agencies’ contributions on behalf of employees.
- Appropriations (for “employer” share related to retirement program annuitants).
- Interest earnings on Treasury securities.

The *Postal Accountability and Enhancement* (Postal Act of 2006) (Public Law No 109-435, Title VIII), made significant changes in the funding of future retiree health benefits for employees of the USPS, including the requirement for the USPS to make scheduled payments to the third HBP trust fund, the Postal Service Retiree Health Benefits (PSRHB) Fund.

The laws establishing the PSRHB Fund and authorizing the depositing of amounts to the credit of the trust fund are set forth in 5 U.S.C. § 8909a. Public Law 109-435 requires the USPS to make scheduled payment contributions to the PSRHB Fund ranging from \$5.4 billion to \$5.8 billion per year from fiscal year 2007 through fiscal year 2016. (The fiscal year 2009 payment was subsequently reduced to \$1.4 billion.) Thereafter, the USPS will make annual payments in the amount of the normal cost payment. The PSRHB Fund is also funded by interest earnings on Treasury securities. However, because of fiscal year 2012 Continuing Resolutions enacted by Congress, including P.L. 112-74, the USPS had no payment due on September 30, 2011. There were two payments due in fiscal year 2012, one for \$5.5 billion due by August 1, 2012, and a second payment of \$5.6 billion due by September 30, 2012, a total of \$11.1 billion. As of September 30, 2012, USPS has defaulted on both payments and OPM has recorded receivables for the total amount of \$11.1 billion. At this time, Congress has not taken further action on these payments due to the PSRHB from USPS.

## Federal Disability Insurance Trust Fund

The Federal Disability Insurance Trust Fund provides financial assistance and protection against the loss of earnings due to a wage earner’s disability. The SSA administers this trust fund.

Like the Federal Old-Age and Survivors Insurance Trust Fund, payroll taxes primarily fund the Federal Disability Insurance Trust Fund. The fund also receives income from interest earnings on Treasury securities, Federal agencies’ payments for the Social Security benefits earned by military and Federal civilian employees, and a portion of income taxes collected on Social Security benefits. The law establishing the Federal Disability Insurance Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 401.

## Federal Supplementary Medical Insurance Trust Fund (Medicare Parts B and D)

The Federal Supplementary Medical Insurance Trust Fund, administered by HHS, finances the Supplementary Medical Insurance Program (Medicare Part B) and the Medicare Prescription Drug Benefit Program (Medicare Part D). These programs provide supplementary medical insurance for enrolled eligible participants to cover physician and outpatient services not covered by Medicare Part A and to obtain qualified prescription drug coverage, respectively. Medicare Part B financing is not based on payroll taxes; it is primarily based on monthly premiums, income from the General Fund of the Treasury, and interest earnings on Treasury securities. The law establishing the Federal Supplementary Medical Insurance Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 1395t.

Medicare Part D was created by the *Medicare Prescription Drug, Improvement, and Modernization Act of 2003* (Public Law No. 108-173). Medicare Part D financing is similar to Part B; it is primarily based on monthly premiums and income from the General Fund of the Treasury, not on payroll taxes. It also receives transfers from States. The law creating the Medicare prescription drug account within the Federal Supplementary Medical Insurance Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 1395w-116.

## Exchange Stabilization Fund (ESF)

The Exchange Stabilization Fund may be used by the Secretary of Treasury to purchase or sell currencies, to hold U.S. foreign exchange and SDR assets, and to provide financing to foreign governments. Appropriations, U.S. SDR assets in the International Monetary Fund, investments in Treasury securities, and investments in Foreign Currency Denominated assets are the sources of revenues or financing sources to the ESF. The law establishing the ESF account and authorizing the use of its funds is section 10 of the Gold Reserve Act of 1934, as amended (31 U.S.C. § 5302).

## All Other Earmarked Funds

The Government is responsible for the management of numerous earmarked funds that serve a wide variety of purposes. The earmarked funds presented on an individual basis in the preceding table represent the majority of the Government's net position attributable to earmarked funds. All other earmarked activity is aggregated in accordance with SFFAS No. 27. For the years ending September 30, 2012, and 2011, there were approximately 623 and 630 earmarked funds, respectively. The earmarked funds within the "all other" aggregate, along with the agencies that administer them, include the following:

- Unemployment Trust Fund (UTF) and Black Lung Disability Trust Fund (BLDTF)—administered by DOL.
- Railroad Retirement Trust Fund—administered by RRB.
- National Flood Insurance Program—administered by DHS.
- Land and Water Conservation Fund, Reclamation Fund, Water and Related Resources Fund, and Lower Colorado River Basin Fund—administered by DOI.
- Highway Trust Fund and Airport and Airway Trust Fund—administered by DOT.
- Government National Mortgage Association—administered by HUD.
- National Telecommunications and Information Administration Digital Television Transition and Public Safety Fund and Broadband Technology Opportunities Program-Recovery Act Fund—administered by the Department of Commerce (DOC).
- Decommissioning and Decontamination Fund—administered by DOE.
- Investor Protection Fund—administered by the Securities and Exchange Commission (SEC).
- Universal Service Fund—administered by the Federal Communication Commission (FCC).
- Crime Victims Fund—administered by DOJ.
- Federal Employees' Life Insurance Fund—administered by OPM.
- Superfund (Hazardous Substance) and Leaking Underground Storage Tanks—administered by Environmental Protection Agency (EPA).

## Unemployment and Excise Taxes

### Unemployment Taxes

The Unemployment Trust Fund (UTF), within the "all other" aggregate, represents all the earmarked unemployment tax revenues shown on the consolidated Statement of Operations and Changes in Net Position.

The Unemployment Trust Fund provides temporary assistance to workers who lose their jobs. The program is administered through a unique system of Federal and State partnerships, established in Federal law, but executed through conforming State laws by State officials. DOL administers the Federal operations of the program.

Employer taxes provide the primary funding source for the UTF and constitute all the earmarked unemployment tax revenues as shown on the consolidated Statement of Operations and Changes in Net Position. However, interest earnings on Treasury securities also provide income to the fund. For the years ending September 30, 2012, and 2011, UTF unemployment tax revenues were \$66.5 billion and \$56.1 billion, respectively. Appropriations have supplemented the fund's income during periods of high and extended unemployment. The law establishing the UTF and authorizing the depositing of amounts to the credit of the trust fund is set forth in 42 U.S.C. § 1104.

## Excise Taxes

There are 10 earmarked funds within the “all other” aggregate that represent all of the earmarked excise tax revenue shown on the consolidated Statement of Operations and Changes in Net Position. The Highway Trust Fund and the Airport and Airway Trust Fund, combined, represent more than 90 percent of all earmarked excise tax revenues. Both of these earmarked funds are administered by the DOT and, for more detailed information regarding them, please refer to DOT’s financial statements.

The Highway Trust Fund was established to promote domestic interstate transportation and to move people and goods. The fund provides Federal grants to States for highway construction, certain transit programs, and related transportation purposes. The law establishing the Highway Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 26 U.S.C. § 9503. Funding sources include earmarked excise taxes on gasoline and other fuels, certain tires, the initial sale of heavy trucks, and highway use by commercial motor vehicles. For the years ending September 30, 2012, and 2011, Highway Trust Fund excise tax revenues were \$40.2 billion and \$36.9 billion, respectively. As funds are needed for payments, the Highway Trust Fund corpus investments are liquidated and funds are transferred to the Federal Highway Administration, the Federal Transit Administration, or other DOT entities, for payment of obligations.

The Airport and Airway Trust Fund provides for airport improvement and airport facilities maintenance. It also funds airport equipment, research, and a portion of the Federal Aviation Administration’s administrative operational support. The law establishing the Airport and Airway Trust Fund and authorizing the depositing of amounts to the credit of the trust fund is set forth in 26 U.S.C. § 9502. Funding sources include:

- Taxes received from transportation of persons and property in the air and fuel used in commercial and general aviation.
- International departure taxes.
- Interest earnings on Treasury securities.

For the years ending September 30, 2012, and 2011, Airport and Airway Trust Fund excise tax revenues were \$12.5 billion and \$11.5 billion, respectively. These revenue amounts do not reflect any transfers from the Highway Trust Fund to the Airport and Airway Trust Fund for fuel which was used in aviation, but which was taxed at highway rates under P.L. 109-59 Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users.

## Miscellaneous Earned Revenues

Miscellaneous earned revenues due to earmarked funds activity primarily relate to royalties retained by various earmarked funds within DOI.

## Intra-Earmarked Fund Eliminations

The intra-earmarked fund eliminations represent the activity between earmarked funds that are administered by different Federal agencies and which are eliminated to produce consolidated earmarked revenues and net costs as shown on the Statement of Operations and Changes in Net Position. Significant examples of such intra-earmarked fund activity include the financial interchanges and transactions between the Railroad Retirement Trust Fund, the Social Security Trust Funds, and the Medicare Trust Funds, which are administered by the RRB, SSA and HHS, respectively. The financial interchanges and transactions between RRB’s Railroad Retirement Trust Fund, SSA’s Federal Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, and HHS’ Federal Hospital Insurance Trust Fund are intended to put the latter three trust funds in the same position they would have been, had railroad employment been covered under the Social Security Act. For further information, see the Railroad Retirement program description within Note 26—Social Insurance.

## Note 25. Fiduciary Activities

Fiduciary activities are the collection or receipt, and the management, protection, accounting, investment and disposition by the Government of cash or other assets in which non-Federal individuals or entities have an ownership interest that the Government must uphold. Fiduciary cash and other assets are not assets of the Government and accordingly are not recognized on the consolidated Governmentwide Balance Sheet. Examples of the Government's fiduciary activities include the Thrift Savings Plan, which is administered by the Federal Retirement Thrift Investment Board, and the Indian Tribal and individual Indian Trust Funds, which are administered by the DOI.

### Schedule of Fiduciary Net Assets as of September 30, 2012, and 2011

(In billions of dollars)	2012	2011
FRTIB-Thrift Savings Plan .....	329.2	281.6
Department of the Interior .....	4.5	3.8
All other .....	5.7	5.8
Total fiduciary net assets.....	<u>339.4</u>	<u>291.2</u>

In accordance with the requirements of SFFAS No. 31, *Accounting for Fiduciary Activities*, fiduciary investments in Treasury securities and fund balance with Treasury held by fiduciary funds are to be recognized on the Governmentwide Balance Sheet as debt held by the public and as liability for fiduciary fund balance with Treasury, respectively. Refer to Note 14—Federal Debt Securities Held by the Public and Accrued Interest for more information on Treasury securities.

As of September 30, 2012, total fiduciary investments in Treasury securities and in non-Treasury securities are \$158.2 billion and \$175.2 billion, respectively. As of September 30, 2011, total fiduciary investments in Treasury securities and in non-Treasury securities are \$143.9 billion and \$145.1 billion, respectively. As of September 30, 2012, and 2011, the total fiduciary fund balance with Treasury is \$1.2 billion. A liability for this fiduciary fund balance with Treasury is reflected as other miscellaneous liabilities in Note 19—Other Liabilities.

As of September 30, 2012, and 2011, collectively, the fiduciary investments in Treasury securities and fiduciary fund balance with Treasury held by all Government entities represent \$4.3 billion and \$4.0 billion, respectively, of unrestricted cash included within cash held by Treasury for Governmentwide Operations shown in Note 2—Cash and Other Monetary Assets.

### Federal Retirement Thrift Investment Board (FRTIB)-Thrift Savings Plan

The TSP is administered by an independent Government agency, the FRTIB, which is charged with operating the TSP prudently and solely in the interest of the participants and their beneficiaries. Assets of the TSP are maintained in the Thrift Savings Fund (the Plan).

The TSP is a retirement savings and investment plan for Federal employees and members of the uniformed services. It was authorized by the United States Congress in the Federal Employees' Retirement System Act of 1986. The Plan provides Federal employees and members of the uniformed services with a savings and tax benefit similar to what many private sector employers offer their employees. The Plan was primarily designed to be a key part of the retirement package (along with a basic annuity benefit and Social Security) for employees who are covered by the FERS.

As of September 30, 2012, and 2011, the TSP held \$329.2 billion and \$281.6 billion, respectively, in net assets, which included \$153.9 billion and \$139.3 billion, respectively, of U.S. Government Securities (amounts are unaudited). The most recent audited financial statements for the TSP are as of December 31, 2011, and 2010. As of December 31, 2011, and 2010, the TSP held \$298.1 billion and \$281.0 billion, respectively, in net assets, which included \$147.7 billion and \$124.7 billion, respectively, of U.S. Government Securities. These unaudited amounts above are included to enhance comparability of the TSP net assets with the remainder of the Government's fiduciary net assets as of September 30, 2012, and 2011.

Federal employees, who are participants of FERS, the CSRS, or equivalent retirement systems, as provided by statute, and members of the uniformed services, are eligible to join the Plan immediately upon being hired. Generally, FERS employees are those employees hired on or after January 1, 1984, while CSRS employees are employees hired before January 1, 1984, who have not elected to convert to FERS. Each group has different rules that govern contribution rates. As of December 31, 2011, and 2010, there were approximately 4.5 million and 4.4 million participants in the TSP, respectively, with approximately 2.9 million contributing their own money. For further information about FRTIB and the TSP, please refer to the FRTIB website at <http://www.frtib.gov>.

## DOI–Indian Trust Funds

As stated above, DOI has responsibility for the assets held in trust on behalf of American Indian Tribes and individuals, and these account for all of DOI's fiduciary net assets. DOI maintains accounts for Tribal and Other Trust Funds (including the Alaska Native Escrow Fund and Individual Indian Money Trust Funds) in accordance with the American Indian Trust Fund Management Reform Act of 1994. The fiduciary balances that have accumulated in these funds have resulted from land use agreements, royalties on natural resource depletion, other proceeds derived directly from trust resources, judgment awards, settlements of claims, and investment income. These funds are maintained for the benefit of individual Native Americans as well as for designated Indian tribes. DOI maintains separate Financial Statements for these trust funds which were prepared using the cash or modified cash basis of accounting, a comprehensive basis of accounting other than GAAP. The independent auditors' reports were qualified as it was not practical to extend audit procedures sufficiently to satisfy themselves as to the fairness of the trust fund balances. For further information related to these assets, see the financial statements of the DOI.

## All Other Entities with Fiduciary Activities

The Government is responsible for the management of other fiduciary net assets on behalf of various non-Federal entities. The component agencies presented individually in the table on the previous page represent the vast majority of the Government's fiduciary net assets. All other component entities with fiduciary net assets are aggregated in accordance with SFFAS No. 31. As of September 30, 2012, and 2011, including FRTIB and DOI, there are a total of 16 and 15 Federal entities, respectively, with fiduciary activities with a grand total of 59 and 58 fiduciary funds, respectively. For further information relating to the fiduciary activities of the remaining component entities within the "all other" aggregate, please refer to the financial statements for:

- Small Business Administration
- Library of Congress
- Department of the Treasury
- Department of State
- Department of Defense
- Department of Transportation
- Department of Labor
- Department of Agriculture
- Smithsonian Institution
- Department of Commerce
- National Labor Relations Board
- American Battle Monuments Commission
- Government Accountability Office, and
- Peace Corps.



## Note 26. Social Insurance

The Statement of Social Insurance presents the projected actuarial present value of the estimated future revenue and estimated future expenditures of the Social Security, Medicare, Railroad Retirement, and Black Lung social insurance programs which are administered by the SSA, HHS, RRB, and DOL, respectively. These estimates are based on the economic and demographic assumptions presented later in this note as set forth in the relevant Social Security and Medicare trustees' reports and in the agency financial report of HHS and in the relevant agency performance and accountability reports for SSA and RRB and the annual financial report for DOL. The projections are based on the continuation of program provisions contained in current law. The estimates in the consolidated SOSI of the open group measures are for persons who are participants or eventually will participate in the programs as contributors (workers) or beneficiaries (retired workers, survivors, and disabled) during the 75-year projection period (Black Lung is projected only through September 30, 2040, because the projection period will terminate on September 30, 2040).

Contributions and earmarked taxes consist of: payroll taxes from employers, employees, and self-employed persons; revenue from Federal income taxation of Old-Age Survivors and Disability Insurance (OASDI) and railroad retirement benefits; excise tax on coal (Black Lung); and premiums from, and State transfers on behalf of, participants in Medicare; and reimbursements from the General Fund of the Treasury to the OASDI trust funds to make up for reductions in payroll tax revenue due to temporary payroll tax rate reductions. Income for all programs is presented from a consolidated perspective. Future interest payments and other future intragovernmental transfers have been excluded upon consolidation. Expenditures include scheduled benefit payments and administrative expenses. Scheduled benefits are projected based on the benefit formulas under current law. However, current Social Security and Medicare law provides for full benefit payments only to the extent that there are sufficient balances in the trust funds.

Actuarial present values of estimated future revenue (excluding interest) and estimated future expenditures for the Social Security, Medicare, and Railroad Retirement social insurance programs are presented for three different groups of participants: (1) current participants who have attained eligibility age, (2) current participants who have not attained eligibility age, and (3) future participants who are new entrants expected to become participants in the future. Current participants in the Social Security and Medicare programs form the "closed group" of taxpayers and/or beneficiaries who are at least 15 years of age at the start of the projection period. Since the projection period for the Social Security, Medicare, and Railroad Retirement social insurance programs consists of 75 years, the period covers virtually all of the current participants' working and retirement years, a period that could be greater than 75 years in a relatively small number of instances. Future participants for Social Security and Medicare include births during the projection period and individuals below age 15 as of January 1 of the valuation year. Railroad Retirement's future participants are the projected new entrants as of January 1 of the valuation year.

The present values of future expenditures in excess of future revenue are calculated by subtracting the actuarial present values of future scheduled contributions and dedicated tax income by and on behalf of current and future participants from the actuarial present value of the future scheduled benefit payments to them or on their behalf. To determine a program's funding shortfall over any given period of time, the starting trust fund balance is subtracted from the present value of expenditures in excess of revenues over the period.

The trust fund balances as of the valuation date for the respective programs, including interest earned, are in the table shown below. Substantially all of the Social Security (OASDI) and Medicare Hospital Insurance (HI), and Supplementary Medical Insurance (SMI) trust fund balances consist of investments in special non-marketable U.S. Treasury securities that are backed by the full faith and credit of the U.S. Government.

(In billions of dollars)	2012	2011	2010	2009	2008
Social Security.....	2,678	2,609	2,540	2,419	2,238
Medicare:					
HI .....	244	272	304	321	312
SMI Part B .....	80	71	76	59	53
SMI Part D .....	1	1	1	1	3
Railroad Retirement .....	24	26	25	22	33
Black Lung.....	(6)	(6)	(6)	(6)	(10)

<sup>1</sup> As of the valuation date of the respective programs.

## Social Security

The Old-Age and Survivors Insurance (OASI) program, created in 1935, and the Disability Insurance program, created in 1956, collectively referred to as OASDI or “Social Security,” provides cash benefits for eligible U.S. citizens and residents. Eligibility and benefit amounts are determined under the laws applicable for the period. Current law provides that the amount of the monthly benefit payments for workers, or their eligible dependents or survivors, is based on the workers’ lifetime earnings histories.

The primary financing of the OASDI Trust Funds are taxes paid by workers, their employers, and individuals with self-employment income, based on work covered by the OASDI Program. Refer to Unaudited Required Supplementary Information—Social Insurance section for additional information on Social Security program financing.

That portion of each trust fund not required to pay benefits and administrative costs is invested, on a daily basis, in interest-bearing obligations of the U.S. Government. The Social Security Act authorizes the issuance by the Treasury of special nonmarketable, intragovernmental debt obligations for purchase exclusively by the trust funds. Although the special issues cannot be bought or sold in the open market, they are redeemable at any time at face value and thus bear no risk of fluctuation in principal value due to changes in market yield rates. Interest on the bonds is credited to the trust funds and becomes an asset to the funds and a liability to the General Fund of the Treasury. These Treasury securities and related interest are eliminated in consolidation at the Governmentwide level.

## Medicare

The Medicare Program, created in 1965, has two separate trust funds: the HI (Medicare Part A) and SMI (Medicare Parts B and D) Trust Funds. HI pays for inpatient acute hospital services and major alternatives to hospitals (skilled nursing services, for example) and SMI pays for hospital outpatient services, physician services, and assorted other services and products through the Part B account and pays for prescription drugs through the Part D account. Though the events that trigger benefit payments are similar, HI and SMI have different earmarked financing structures. Similar to OASDI, HI is financed primarily by payroll contributions. Other income to the HI Trust Fund includes a small amount of premium income from voluntary enrollees, a portion of the Federal income taxes that beneficiaries pay on Social Security benefits and interest credited on Treasury securities held in the HI Trust Fund. These Treasury securities and related interest are eliminated in the consolidation at the Governmentwide level.

For SMI, transfers from the General Fund of the Treasury represent the largest source of income for both Parts B and D. Generally, beneficiaries finance the remainder of Parts B and D costs via monthly premiums to these programs. With the introduction of Part D drug coverage, Medicaid is no longer the primary payer for beneficiaries dually eligible for Medicare and Medicaid. For those beneficiaries, States must pay a portion of their estimated foregone drug costs into the Part D account (referred to as State transfers). As with HI, interest received on Treasury securities held in the SMI Trust Fund is credited to the fund and these Treasury securities and related interest are eliminated in consolidation at the Governmentwide level. Refer to Unaudited Required Supplementary Information—Social Insurance section for additional information on Medicare program financing.

The Medicare Prescription Drug, Improvement, and Modernization Act (MMA), enacted on December 8, 2003, created the Part D account in the SMI Trust Fund to account for the prescription drug benefit that began in 2006. The MMA established within SMI two Part D accounts related to prescription drug benefits: the Medicare Prescription Drug Account and the Transitional Assistance Account. The Medicare Prescription Drug Account was used in conjunction with the broad, voluntary prescription drug benefits that commenced in 2006. The Transitional Assistance Account was used to provide transitional assistance benefits, beginning in 2004 and extending through 2005, for certain low-income beneficiaries prior to the start of the new prescription drug benefit.

### **Affordable Care Act (ACA)**

The financial projections for the Medicare program reflect substantial, but very uncertain, cost savings deriving from provisions of the Affordable Care Act. However, it is important to note that the improved results for HI and SMI Part B since 2010 depend in part on the long-range feasibility of the various cost-saving measures in the Affordable Care Act—in particular, the lower increases in Medicare payment rates to most categories of health care providers. Without fundamental change in the current delivery system, these adjustments would probably not be viable indefinitely. It is possible that health care providers could improve their productivity, reduce wasteful expenditures, and take other steps to keep their cost growth within the bounds imposed by the Medicare price limitations. For such efforts to be successful in the long range, providers would have to generate and sustain unprecedented levels of productivity gains—a very challenging and uncertain prospect.

A transformation of health care in the United States, affecting both the means of delivery and the method of paying for care, is also a possibility. The Affordable Care Act takes important steps in this direction by initiating programs of research into innovative payment and service delivery models, such as accountable care organizations, patient-centered “medical homes,” improvement in care coordination for individuals with multiple chronic health conditions, improvement in coordination of post-acute care, payment bundling, “pay for performance,” and assistance for individuals in making informed health choices. If researchers and policy makers can demonstrate that the new approaches developed through these initiatives will improve the quality of health care and/or reduce costs, then the Secretary of Health and Human Services can adopt them for Medicare without further legislation. Such changes have the potential to reduce health care costs and cost growth rates and could, as a result, help lower Medicare cost growth rates to levels compatible with the lower price updates payable under current law.

The ability of new delivery and payment methods to significantly lower cost growth rates is uncertain at this time, since specific changes have not yet been designed, tested, or evaluated. Hopes for success are high, but at this time there is insufficient evidence to support an assumption that improvements in efficiency can occur of the magnitude needed to align with the statutory Medicare price updates.

The reduction in provider payment updates, if implemented for all future years as required under current law, could have secondary impacts on provider participation, beneficiary access to care; quality to services; and other factors. These possible impacts are very speculative and at present there is no consensus among experts as to their potential scope. Further research and analysis will help to better inform this issue and may enable the development of specific projections of secondary effects under current law in the future.

In addition, the Medicare Part B projections reflect a reduction of almost 31 percent in payment rates for physician services in 2013, as estimated in the 2012 Trustee Report, which is assumed to be implemented as required under current law. If lawmakers act to prevent this decrease, as they have for 2003 through 2012, and do not offset this action with reductions in other provisions of the program, then actual Part B and total SMI costs will significantly exceed the projections shown in this report.

Because knowledge of the potential long-range effects of the productivity adjustments, delivery and payment innovations, and certain other aspects of the Affordable Care Act is so limited, in August 2010, the Secretary of the Department of Health and Human Services, working on behalf of the Board of Trustees, established an independent group of expert actuaries and economists to review the assumptions and methods used by the Trustees to make projections of the financial status of the trust funds. The members of the Panel began their deliberations in

November 2010 and were asked to focus their immediate attention on the long-range Medicare cost growth assumptions.

In December 2011, the panel members unanimously recommended a new approach that builds on the longstanding “Gross Domestic Product (GDP) plus 1 percent” assumption while incorporating several key refinements. Both the Office of the Actuary at Center for Medicare & Medicaid Services (CMS) and the Board of Trustees support these recommendations, and they form the basis for the long-range cost growth assumptions used in this FR. The new methodology is explained in more detail in section IV.D of the 2012 Medicare Trustees Report.

The Panel also recommended the continued use of a supplemental analysis, similar to the illustrative alternative projection in the 2010 and 2011 Trustees Reports, for the purpose of illustrating the higher Medicare costs that would result if the reduction in physician payment rates and the productivity adjustments to most other provider payment updates are not fully implemented as required under current law.<sup>1</sup>

The SOSI projections are based on current law. Therefore, the productivity adjustments are assumed to occur in all future years, as required by the Affordable Care Act. In addition, an approximate 31 percent reduction in Medicare payment rates for physician services in January 2013, as estimated in the 2012 Trustee Report, is assumed to be implemented as required under current law, despite the virtual certainty that Congress will continue to override this reduction. Therefore, it is important to note that the actual future costs for Medicare are likely to exceed those shown by these current-law projections.

The extent to which actual future Part A and Part B costs exceed the projected current-law amounts due to changes to the productivity adjustments and physician payments depends on both the specific changes that might be legislated and on whether Congress would pass further provisions to help offset such costs. As noted, these examples only reflect hypothetical changes to provider payment rates.

It is likely that in the coming years, Congress will consider, and pass, numerous other legislative proposals affecting Medicare. Many of these will likely be designed to reduce costs in an effort to make the program more affordable. In practice, it is not possible to anticipate what actions Congress might take, either in the near term or over longer periods. Please see Note 28—Subsequent Events for additional information.

The Medicare Board of Trustees, in their annual report to Congress, references an alternative scenario to illustrate when possible, the potential understatement of Medicare costs and projection results. This alternative scenario assumes that the productivity adjustments are gradually phased down during 2020 to 2034 and that the physician fee reductions are overridden. These examples were developed for illustrative purposes only; the calculations have not been audited; no endorsement of the illustrative alternative to current law by the Trustees, CMS, or the CMS Office of the Actuary, should be inferred; and the examples do not attempt to portray likely or recommended future outcomes. Thus the illustrations are useful only as general indicators of the substantial impacts that could result from future legislation affecting the productivity adjustments and physician payments under Medicare and of the broad range of uncertainty associated with such impacts. The table below contains a comparison of the Medicare 75-year present values of income and expenditures under current law with those under the alternative scenario illustration.

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<sup>1</sup> The *Interim Report of the Technical Panel of the Medicare Trustees Report* is available at <http://aspe.hhs.gov/health/medpanel/2010/interim1103.shtml>. Once completed, the final report will be available at <http://aspe.hhs.gov/health/medpanel/2010/>.

<b>Medicare Present Values (in billions) (Unaudited)</b>		
	<b>2012 Consolidated SOSI</b>	<b>Illustrative Alternative Scenario <sup>1, 2</sup></b>
<b>Income</b>		
Part A.....	\$15,598	\$15,600
Part B <sup>3</sup> .....	5,344	7,435
Part D <sup>4</sup> .....	2,349	2,351
Total income .....	<u>\$23,291</u>	<u>\$25,386</u>
<b>Expenditures</b>		
Part A.....	\$21,179	\$25,494
Part B.....	20,159	28,007
Part D.....	9,128	9,129
Total expenditures .....	<u>\$50,466</u>	<u>\$62,630</u>
Part A .....	\$5,581	\$9,895
Part B .....	14,815	20,572
Part D .....	6,778	6,778
Excess of expenditures over income.....	<u><u>\$27,174</u></u>	<u><u>\$37,245</u></u>
<p><sup>1</sup> These amounts are not presented in the 2012 Trustees' Report.</p> <p><sup>2</sup> At the request of the Trustees, the Office of the Actuary at CMS has prepared an illustrative set of Medicare Trust Fund projections that differ from current law. No endorsement of the illustrative alternative to current law by the Trustees, CMS, or the Office of the Actuary should be inferred.</p> <p><sup>3</sup> Excludes \$14,815 billion and \$20,572 billion of General Revenue Contributions from the 2012 Consolidated SOSI projection and the Illustrative Alternative Scenario's projection, respectively; i.e., to reflect Part B income on a consolidated Governmentwide basis.</p> <p><sup>4</sup> Excludes \$6,778 billion of General Revenue Contributions from both the 2012 Consolidated SOSI projection and the Illustrative Alternative Scenario's projection, respectively; i.e., to reflect Part D income on a consolidated Governmentwide basis.</p> <p>Note: Amounts may not add due to rounding.</p>		

As expected, the differences between the current-law projections and the illustrative alternative are substantial for Part A and Part B, although both represent a sizeable improvement in the financial outlook for Medicare compared to the laws in effect prior to the ACA. This difference in outlook serves as a compelling reminder of the importance of developing and implementing further means of reducing health care cost growth in the coming years. All Part A fee-for-service providers are affected by the productivity adjustments, so the current law projections reflect an estimated 1.1 percent reduction in annual Part A cost growth each year. If the productivity adjustments were gradually phased out, as illustrated under the alternative scenario, the present value of Part A expenditures is estimated to be roughly 20 percent higher than the current-law projection. As indicated above, the present value of Part A income is basically unaffected under the alternative scenario.

The Part B expenditure projections are significantly higher under the alternative scenario than under current law, both because of the assumed gradual phase-out of the productivity adjustments and the assumption that the scheduled physician fee reductions would be overridden and based on 1 percent annual increases through 2021, based on a recommendation by the 2010-2011 Medicare Technical Review Panel. The productivity adjustments are assumed to affect more than half of Part B expenditures at the time their phase-out is assumed to begin. Similarly, physician fee schedule services are assumed to be roughly 30 percent higher under the alternative scenario than under current law at that time. The combined effect of these two factors results in a present value of Part B expenditures under the alternative scenario that is approximately 39 percent higher than the current-law projection.

The Part D projections are basically unaffected under the alternative projection because the services are not impacted by the productivity adjustments or the physician fee schedule reductions. The very minor impact is the result of a slight change in the discount rates that are used to calculate present values.

### **Social Security and Medicare—Demographic and Economic Assumptions**

The Boards of Trustees<sup>2</sup> of the OASDI and Medicare Trust Funds provide in their annual reports to Congress short-range (10-year) and long-range (75-year) actuarial estimates of each trust fund. Because of the inherent uncertainty in estimates for 75 years into the future, the Boards use three alternative sets of economic and demographic assumptions to show a range of possibilities. Assumptions are made about many economic and demographic factors, including GDP, earnings, the CPI, the unemployment rate, the fertility rate, immigration, mortality, disability incidence and terminations and, for the Medicare projections, health care cost growth. The assumptions used for the most recent set of projections shown in Tables 1A (Social Security) and Table 1B (Medicare) are generally referred to as the “intermediate assumptions,” and reflect the trustees’ reasonable estimate<sup>3</sup> of expected future experience. For further information on Social Security and Medicare demographic and economic assumptions, refer to SSA’s Performance and Accountability Report and HHS’ Agency Financial Report.

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<sup>2</sup> There are six trustees: the Secretaries of the Treasury (managing trustee), Health and Human Services, and Labor; the Commissioner of the Social Security Administration; and two public trustees who are generally appointed by the President and confirmed by the Senate for a 4-year term. By law, the public trustees are members of two different political parties.

<sup>3</sup> Statement of Federal Financial Accounting Standard (SFFAS) No. 33: *Pensions, Other Retirement Benefits, and Other Postemployment Benefits*: Reporting the Gains and Losses From Changes in Assumptions and Selecting Discount Rates and Valuation Dates, effective for fiscal years beginning after September 30, 2009, revised SFFAS No. 17: *Accounting for Social Insurance*, paragraphs 25, 27 (2), and 27 (4), by replacing the term “best estimate” with “reasonable estimate.”

**Table 1A**  
**Social Security – Demographic and Economic Assumptions**

Demographic Assumptions					
Year	Total Fertility Rate <sup>1</sup>	Age-Sex Adjusted Death Rate <sup>2</sup> (per 100,000)	Net Immigration <sup>3</sup> (persons)	Period Life Expectancy at Birth <sup>4</sup>	
				Male	Female
2012	2.04	759.3	960,000	76.1	80.6
2020	2.04	708.6	1,205,000	77.1	81.3
2030	2.02	650.4	1,125,000	78.3	82.3
2040	2.00	598.8	1,075,000	79.4	83.2
2050	2.00	553.3	1,050,000	80.4	84.0
2060	2.00	513.2	1,040,000	81.3	84.8
2070	2.00	477.7	1,035,000	82.2	85.5
2080	2.00	446.0	1,030,000	83.0	86.2
2090	2.00	417.7	1,025,000	83.8	86.8

Economic Assumptions						
Year	Real Wage Differential <sup>5</sup> (percent)	Average Annual Wage in Covered Employment <sup>6</sup> (percent change)	CPI <sup>7</sup> (percent change)	Real GDP <sup>8</sup> (percent change)	Total Employment <sup>9</sup> (percent change)	Average Annual Interest Rate <sup>10</sup> (percent)
2020	1.3	4.1	2.8	2.2	0.6	5.6
2030	1.1	3.9	2.8	2.0	0.4	5.7
2040	1.2	4.0	2.8	2.2	0.6	5.7
2050	1.1	3.9	2.8	2.1	0.5	5.7
2060	1.1	3.9	2.8	2.1	0.4	5.7
2070	1.1	3.9	2.8	2.1	0.4	5.7
2080	1.1	3.9	2.8	2.0	0.4	5.7
2090	1.2	4.0	2.8	2.0	0.4	5.7

<sup>1</sup> The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime if she were to experience the birth rates by age observed in, or assumed for, the selected year, and if she were to survive the entire childbearing period. The assumed total fertility rate does not change after 2036.

<sup>2</sup> The age-sex-adjusted death rate is the crude rate that would occur in the enumerated total population as of April 1, 2000, if that population were to experience the death rates by age and sex observed in, or assumed for, the selected year.

<sup>3</sup> Net immigration is the number of persons who enter during the year (both legally and otherwise) minus the number of persons who leave during the year. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

<sup>4</sup> The period life expectancy at a given age for a given year is the average number of years of life remaining if a group of persons at that exact age, born on January 1, were to experience the mortality rate for that year over the course of their remaining lives.

<sup>5</sup> The real-wage differential is the difference between the percentage increases, before rounding, in the average annual wage in covered employment, and the average annual CPI.

<sup>6</sup> The average annual wage in covered employment is the total amount of wages and salaries for all employment covered by the OASDI program in a year divided by the number of employees with any such earnings during the year. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

<sup>7</sup> The CPI is the annual average value for the calendar year of the CPI for urban wage earners and clerical workers (CPI-W).

<sup>8</sup> The real GDP is the value of total output of goods and services produced in the U.S., expressed in 2005 dollars. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

<sup>9</sup> Total employment is the sum of the U.S. civilian and military employment. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

<sup>10</sup> The average annual interest rate is the average of the nominal interest rates, which, are compounded semiannually, for special public-debt obligations issuable to the trust funds in each of the 12 months of the year. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

**Table 1B**  
**Medicare – Demographic and Economic Assumptions**

Demographic Assumptions								
Year	Total Fertility Rate <sup>1</sup>	Age-Sex		Net Immigration <sup>3</sup> (persons)				
		Adjusted Death Rate <sup>2</sup> (per 100,000)						
2012	2.04	759.3		960,000				
2020	2.04	708.6		1,205,000				
2030	2.02	650.4		1,125,000				
2040	2.00	598.8		1,075,000				
2050	2.00	553.3		1,050,000				
2060	2.00	513.2		1,040,000				
2070	2.00	477.7		1,035,000				
2080	2.00	446.0		1,030,000				

Economic Assumptions								
Year	Real Wage Differential <sup>4</sup> (percent)	Average Annual Wage in Covered Employment (percent change)	CPI <sup>5</sup> (percent change)	Real GDP <sup>6</sup> (percent change)	Per Beneficiary Cost (percent change) <sup>7</sup>			Real Interest Rate <sup>8</sup> (percent)
					HI	SMI		
						Part B	Part D	
2012	1.7	3.8	2.0	2.6	(0.1)	3.9	2.1	0.4
2020	1.3	4.1	2.8	2.2	3.8	5.3	6.2	2.7
2030	1.1	3.9	2.8	2.0	4.9	4.8	5.5	2.9
2040	1.2	4.0	2.8	2.2	5.4	4.5	5.3	2.9
2050	1.1	3.9	2.8	2.1	4.1	4.1	5.0	2.9
2060	1.1	3.9	2.8	2.1	4.0	4.1	4.8	2.9
2070	1.1	3.9	2.8	2.1	4.1	3.9	4.6	2.9
2080	1.1	3.9	2.8	2.0	3.7	3.8	4.5	2.9

<sup>1</sup> The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime if she were to experience the birth rates by age observed in, or assumed for, the selected year, and if she were to survive the entire childbearing period. The assumed total fertility rate does not change after 2036.

<sup>2</sup> The age-sex-adjusted death rate is the crude rate that would occur in the enumerated total population as of April 1, 2000, if that population were to experience the death rates by age and sex observed in, or assumed for, the selected year.

<sup>3</sup> Net immigration is the number of persons who enter during the year (both legally and otherwise) minus the number of persons who leave during the year. It is a summary measure and not a basic assumption; it summarizes the basic assumptions from which it is derived.

<sup>4</sup> The real-wage differential is the difference between the percentage increases, before rounding, in the average annual wage in covered employment, and the average annual CPI.

<sup>5</sup> The CPI is the annual average value for the calendar year of the CPI for urban wage earners and clerical workers.

<sup>6</sup> The real GDP is the value of total output of goods and services produced in the U.S., expressed in 2005 dollars. It is a summary measure and not a basic assumption; it summarizes the effects of the basic assumptions from which it is derived.

<sup>7</sup> These increases reflect the overall impact of more detailed assumptions that are made for each of the different types of service provided by the Medicare program (for example, hospital care, physician services, and pharmaceutical costs). These assumptions include changes in the payment rates, utilization, and intensity of each type of service.

<sup>8</sup> The average annual interest rate earned on new trust fund securities, above and beyond the rate of inflation.



## Railroad Retirement

The Railroad Retirement and Survivor Benefit program pays full retirement annuities at age 60 to railroad workers with 30 years of service. The program pays disability annuities based on total or occupational disability. It also pays annuities to spouses, divorced spouses, widow(er)s, remarried widow(er)s, surviving divorced spouses, children, and parents of deceased railroad workers. Medicare covers qualified railroad retirement beneficiaries in the same way as it does Social Security beneficiaries. The Railroad Retirement and Survivors' Improvement Act of 2001 (RRSIA) liberalized benefits for 30-year service employees and their spouses, eliminated a cap on monthly benefits for retirement and disability benefits, lowered minimum service requirements from 10 to 5 years, and provided for increased benefits for widow(er)s.

The RRB and the SSA share jurisdiction over the payment of retirement and survivor benefits. RRB has jurisdiction if the employee has at least 5 years (if performed after 1995) of railroad service. For survivor benefits, RRB requires that the employee's last regular employment before retirement or death be in the railroad industry. If a railroad employee or his or her survivors do not qualify for railroad retirement benefits, the RRB transfers the employee's railroad retirement credits to SSA.

Payroll taxes paid by railroad employers and their employees are a primary source of income for the Railroad Retirement and Survivor Benefit Program. By law, railroad retirement taxes are coordinated with Social Security taxes. Employees and employers pay tier I taxes at the same rate as Social Security taxes. Tier II taxes finance railroad retirement benefit payments that are higher than Social Security levels.

Other sources of program income include: financial transactions with the Social Security and Medicare Trust Funds, earnings on investments, Federal income taxes on railroad retirement benefits, and appropriations (provided after 1974 as part of a phase out of certain vested dual benefits). The financial interchange between RRB's Social Security Equivalent Benefit (SSEB) Account, the Federal Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, and the Federal Hospital Insurance Trust Fund is intended to put the latter three trust funds in the same position they would have been had railroad employment been covered under the Social Security Act. From a Governmentwide perspective, these future financial interchanges and transactions are intragovernmental transfers and are eliminated in consolidation.

## Railroad Retirement—Employment, Demographic and Economic Assumptions

The most recent set of projections are prepared using employment, demographic and economic assumptions and reflect the Board Members' reasonable estimate of expected future experience.

Three employment assumptions were used in preparing the projections and reflect optimistic, moderate and pessimistic future passenger rail and freight employment. The average railroad employment is assumed to be 226,000 in 2012 under the moderate employment assumption. This employment assumption, based on a model developed by the Association of American Railroads, assumes that (1) passenger service employment will remain at the level of 45,000 and (2) the employment base, excluding passenger service employment, will decline at a constant 2.0 percent annual rate for 25 years, at a falling rate over the next 25 years, and remain level thereafter. All the projections are based on an open-group (i.e., future entrants) population.

The moderate (middle) economic assumptions include a long-term cost of living increase of 2.8 percent, an interest rate of 7.0 percent, and a wage increase of 3.8 percent. The cost of living assumption reflects the expected level of price inflation. The interest rate assumption reflects the expected return on NRRIT investments. The wage increase reflects the expected increase in railroad employee earnings.

Sources of the demographic assumptions including mortality rates and total termination rates, remarriage rates for widows, retirement rates and withdrawal rates, are listed in Table 2. For further details on the employment, demographic, economic and all other assumptions, refer to the *U.S. Railroad Retirement Board Annual Report*, and the *25th Actuarial Valuation of the Assets and Liabilities under the Railroad Retirement Acts* (Valuation Report) as of December 31, 2010, with Technical Supplement.

**Table 2**  
**Railroad Retirement Demographic Actuarial Assumptions (Sources)**

<b>Mortality Rates</b> <sup>1</sup>	Mortality after age retirement	2010 RRB Annuitants Mortality Table
	Mortality after disability retirement	2010 RRB Disabled Mortality Table for Annuitants with Disability Freeze
		2010 RRB Disabled Mortality Table for Annuitants without Disability Freeze
	Mortality during active service	2006 RRB Active Service Mortality Table
	Mortality of widow annuitants	1995 RRB Mortality Table for Widows
<b>Total Termination Rates</b> <sup>2</sup>	Termination for spouses	2010 RRB Spouse Total Termination Table
	Termination for disabled children	2004 RRB Total Termination Table for Disabled Children
<b>Widow Remarriage Rate</b> <sup>3</sup>	1997 RRB Remarriage Table	
<b>Retirement Rates</b> <sup>4</sup>	Age retirement	See the Valuation Report.
	Disability retirement	See the Valuation Report.
<b>Withdrawal Rates</b> <sup>5</sup>	See the Valuation Report.	
<p><sup>1</sup> These mortality tables are used to project the termination of eligible employee benefit payments within the population.</p> <p><sup>2</sup> Total termination rates are used to project the termination of dependent benefits to spouses and disabled children.</p> <p><sup>3</sup> This rate is used to project the termination of spousal survivor benefits.</p> <p><sup>4</sup> The retirement rates are used to determine the expected annuity to be paid based on age and years of service for both age and disability retirees.</p> <p><sup>5</sup> The withdrawal rates are used to project all withdrawals from the railroad industry and resultant effect on the population and accumulated benefits to be paid.</p>		

## Black Lung–Disability Benefit Program

The Black Lung Disability Benefit Program provides for compensation and medical benefits for eligible coal miners who are totally disabled due to pneumoconiosis (black lung disease) as a result of their coal mine employment. The same program also provides for survivor benefits for eligible survivors of coal miners who died due to pneumoconiosis. DOL operates the Black Lung Disability Benefit Program. BLDTF provides benefit payments to eligible coal miners totally disabled by pneumoconiosis and to eligible survivors when no responsible mine operator can be assigned the liability.

Black lung disability benefit payments are funded by excise taxes from coal mine operators based on the sale of coal, as are the fund's administrative costs. These taxes are collected by the Internal Revenue Service (IRS) and transferred to the BLDTF, which was established under the authority of the Black Lung Benefits Revenue Act, and administered by the Treasury. Prior to October 3, 2008, the Black Lung Benefits Revenue Act provided for repayable advances to the BLDTF from the general fund of Treasury, in the event that BLDTF resources were not adequate to meet program obligations.

## Black Lung–Demographic and Economic Assumptions

The demographic assumptions used for the most recent set of projections are the number of beneficiaries and their life expectancy. The beneficiary population data is updated from information supplied by the program. The beneficiary population is a nearly closed universe in which attrition by death exceeds new entrants by a ratio of more than ten to one. SSA Life Tables are used to project the life expectancies of the beneficiary population.

The economic assumptions used for the most recent set of projections are coal excise tax revenue estimates, Federal civilian pay raises, medical cost inflation, and the interest rate on new debt issued by the BLDTF. Projections are sensitive to changes in the tax rate and changes in interest rates on debt issued by the BLDTF.

Estimates of future receipts of the black lung excise tax are based on projections of future coal production and sale prices prepared by the Energy Information Agency of DOE. Treasury's Office of Tax Analysis provides the first 11 years of tax receipt estimates. The remaining years are estimated using a growth rate based on both historical tax receipts and Treasury's estimated tax receipts. The coal excise tax rate structure is \$1.10 per ton of underground-mined coal and \$0.55 per ton of surface-mined coal sold, with a cap of 4.4 percent of sales price. Based on Treasury's interpretation of the Act, the higher excise tax rates will continue until the earlier of December 31, 2018, or the first December 31, in which there exist no (1) balance of repayable debt described in section 9501 of the Internal Revenue Code and (2) unpaid interest on the debt. Starting in 2019, the tax rates revert to \$0.50 per ton of underground-mined coal and \$0.25 per ton of surface-mine coal sold, and a limit of 2.0 percent of sales price.

OMB supplies assumptions for future monthly benefit rate increases based on increases in the Federal pay scale and future medical cost inflation based on increases in the CPIM, which are used to calculate future benefit costs. During the current projection period, future benefit rate increases 2.9 percent in 2013, 3.8 percent in 2014 through 2020, 3.9 percent in each year thereafter, and medical cost increases 3.6 percent in 2013, and ranges from 3.7 percent to 3.8 percent in 2014 through 2017, and 3.9 percent in each year thereafter. Estimates for administrative costs for the first 11 years of the projection are supplied by DOL's Budget Office, based on current year enacted amounts, while later years are based on the number of projected beneficiaries.

Public Law 110-343, Division B—Energy Improvement and Extension Act of 2008, enacted on October 3, 2008, in section 113, (1) allowed for the temporary increase in coal excise tax rates to continue an additional 5 years beyond the current statutory limit, and (2) restructured the BLDTF debt by refinancing the outstanding repayable advances (which had higher interest rates) with the proceeds from issuing discounted debt instruments similar in form to zero-coupon bonds (which had lower interest rates), plus a one-time appropriation. Public Law 110-343 also allowed that any debt issued by the BLDTF subsequent to the refinancing may be used to make benefit payments, other authorized expenditures, or to repay debt and interest from the initial refinancing. All debt issued by the BLDTF was effected as borrowing from the Treasury's Bureau of the Public Debt.

## Statement of Changes in Social Insurance Amounts

The Statement of Changes in Social Insurance Amounts reconciles the change (between the current valuation and the prior valuation) in the present value of future revenue less future expenditures for current and future participants (the open group measure) over the next 75 years (except Black Lung is projected only through September 30, 2040, because the projection period will terminate on September 30, 2040). The reconciliation identifies several components of the changes that are significant and provides reasons for the changes. The following disclosures relate to the Statement of Changes in Social Insurance Amounts including the reasons for the

components of the changes in the open group measure during the reporting period from the end of the previous reporting period for the Government's social insurance programs. The Statement of Changes in Social Insurance Amounts shows two reconciliations: (1) changing from the period beginning on January 1, 2011, to the period beginning on January 1, 2012, and (2) changing from the period beginning on January 1, 2010, to the period beginning on January 1, 2011.

## **Social Security**

All estimates relating to the Social Security Program in the Statement of Changes in Social Insurance Amounts represent values that are incremental to the prior change. As an example, the present values shown for economic data, assumptions, and methods, represent the additional effect of these new data, assumptions, and methods after considering the effects from demography and the change in the valuation period.

## **Assumptions Used for the Components of the Changes for the Social Security Program**

The present values included in the Statement of Changes in Social Insurance Amounts are for the current and prior years and are based on various economic and demographic assumptions used for the intermediate assumptions in the Social Security Trustees Reports for these years. Table 1A summarizes these assumptions for the current year.

### **Period Beginning on January 1, 2011, and Ending January 1, 2012**

Present values as of January 1, 2011, are calculated using interest rates from the intermediate assumptions of the 2011 Social Security Trustees Report. All other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated as a present value as of January 1, 2012. Estimates of the present value of changes in social insurance amounts due to changing the valuation period and changing demographic data, assumptions, and methods are presented using the interest rates under the intermediate assumptions of the 2011 Social Security Trustees Report. Since interest rates are an economic estimate and all estimates in the table are incremental to the prior change, all other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated using the interest rates under the intermediate assumptions of the 2012 Social Security Trustees Report.

### **Period Beginning on January 1, 2010, and Ending January 1, 2011**

Present values as of January 1, 2010 are calculated using interest rates from the intermediate assumptions of the 2010 Social Security Trustees Report. All other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated as a present value as of January 1, 2011. Estimates of the present value of changes in social insurance amounts due to changing the valuation period and changing demographic data, assumptions, and methods are presented using the interest rates under the intermediate assumptions of the 2010 Social Security Trustees Report. Since interest rates are an economic estimate and all estimates in the table are incremental to the prior change, all other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated using the interest rates under the intermediate assumptions of the 2011 Social Security Trustees Report.

## **Changes in Valuation Period**

### **Period Beginning on January 1, 2011, and Ending January 1, 2012**

The effect on the 75-year present values of changing the valuation period from the prior valuation period (2011-85) to the current valuation period (2012-86) is measured by using the assumptions for the prior valuation and extending them in the absence of any changes to the current valuation period. Changing the valuation period removes a small negative net cashflow for 2011, replaces it with a much larger negative net cashflow for 2086, and measures the present values as of January 1, 2012, one year later. Thus, the present value of future net cashflows (excluding the combined OASI and DI Trust Fund assets at the start of the period) decreased (became more negative) when the 75-year valuation period changed from 2011-85 to 2012-86.

### **Period Beginning on January 1, 2010, and Ending January 1, 2011**

The effect on the 75-year present values of changing the valuation period from the prior valuation period (2010-84) in the absence of any changes to the current valuation period (2011-85) is measured by using the assumptions for the prior valuation and extending them to cover the current valuation period. Changing the valuation period removes a small negative net cashflow for 2010 and replaces it with a much larger negative net cashflow for 2085, and measures the present values as of January 1, 2011, one year later. Thus, the present value of future net

cashflows (excluding the combined OASDI and DI Trust Fund assets at the start of the period) decreased (became more negative) when the 75-year valuation period changed from 2010-84 to 2011-85.

## Changes in Demographic Data, Assumptions, and Methods

### Period Beginning January 1, 2011, and Ending January 1, 2012

The ultimate demographic assumptions for the current valuation (beginning on January 1, 2012) are the same as those for the prior valuation. However, the starting demographic values, and the way these values transition to the ultimate assumptions, were changed.

- Preliminary birth rate data for 2009 and 2010 are lower than were expected in the prior valuation. During the period of transition to their ultimate values, the birth rates in the current valuation are generally lower than they were in the prior valuation.
- The current valuation incorporates final data on legal immigration levels for 2010. The levels are slightly lower than the estimates used in the prior valuation.
- Updated starting population levels and the interaction of these levels with the changes in the fertility and immigration assumptions result in higher ratios of retirement age population to working age population than in the prior valuation.

Inclusion of each of these demographic data sets decreases the present value of future net cashflows.

### Period Beginning January 1, 2010, and Ending January 1, 2011

The ultimate demographic assumptions for the current valuation (beginning on January 1, 2011) are the same as those for the prior valuation. However, the starting demographic values were changed.

- The inclusion of final mortality data for 2007 results in lower starting death rates and faster near-term declines in death rates at older ages for the current valuation.
- Revised historical estimates of net other immigration and final data on legal immigration for 2009 are also used in the current valuation. Based on estimates from the Department of Homeland Security for 2007 and 2008 and due to the weak U.S. economy since 2008, net other immigration levels for 2007-2010 are assumed negative for the current valuation. These levels are significantly lower than the positive estimates used in the prior valuation.
- Birth rates projected through 2026 are slightly lower in the current valuation; preliminary birth data for 2008 and 2009 was lower than was expected for the prior valuation.
- Updated starting values of population levels were incorporated in the current valuation.

Except for updating starting values of population levels, inclusion of each of these demographic data sets decreases the present value of future net cashflows.

The following demographic methods were changed in the current valuation (beginning on January 1, 2011).

- The method of determining the initial projected rates of mortality decline was changed to place greater emphasis on recent experience. These initial rates of decline are now determined using the most recent 10 years of historical data, rather than the most recent 20 years. This change increased the rate of decline in death rates at older ages for years following the year of final data (2007) up to the year the ultimate rates of declines are fully in effect (2035).
- The historical estimates of the other immigrant population by age and sex were improved, resulting in greater consistency between the other immigrant population and the total population.

Both of these changes in demographic methods decrease the present value of future net cashflows.

## Changes in Economic Data, Assumptions, and Methods

### Period Beginning on January 1, 2011, and Ending January 1, 2012

The ultimate economic assumptions for the current valuation (beginning January 1, 2012) are the same as those for the prior valuation except for the assumed annual rate of change in average hours worked. The current valuation assumes a decline in average hours worked of 0.05 percent per year rather than no change, as was assumed in the prior valuation. This change lowers the ultimate annual real-wage differential by 0.05 percentage point from the prior valuation, and decreases the present value of future cashflows. In addition, the starting economic values and near-term economic growth rate assumptions were updated to reflect recent developments.

- For the current valuation, OASDI taxable earnings are lower in the starting year, 2011, than were projected for the prior valuation.
- Price inflation in 2011 was higher than expected, with the cost-of-living adjustment to benefits in December 2011 being 2.9 percentage points higher than was assumed in the prior valuation.

- The real interest rate is projected to be lower over the first ten years of the current valuation.
- Inclusion of each of these economic revisions decreases the present value of future net cashflows.

#### **Period Beginning January 1, 2010, and Ending January 1, 2011**

The ultimate economic assumptions for the current valuation (beginning on January 1, 2011) are the same as those for the prior valuation. However, the starting economic values and near-term economic growth rate assumptions were changed. The economic recovery has been slower than was assumed for the prior valuation.

- For the current valuation, OASDI taxable earnings are considerably lower for the starting year 2010, than were projected for the prior valuation. Even though earnings grow faster after 2010 through 2019, the projected level of earnings is lower through 2018 for the current valuation.
- Unemployment rates are slightly higher over first few years of the projection for the current valuation.
- The real interest rate is lower over the first few years of the projection for the current valuation.

Inclusion of each of these economic revisions decreases the present value of future net cashflows.

A change to the methodology for projecting labor force participation was implemented for the current valuation (beginning on January 1, 2011). The assumed effect of gains in life expectancy on labor force participation for persons over 40 was doubled, significantly increasing projected participation rates at higher ages. Disability prevalence was added as an input variable to the labor force model for persons over normal retirement age, partially offsetting increases in the labor force due to changes in life expectancy. Inclusion of these changes to labor force participation projections increase the present value of future net cashflows.

### **Changes in Methodology and Programmatic Data**

#### **Period Beginning on January 1, 2011, and Ending January 1, 2012**

Several methodological improvements and updates of program-specific data are included in the current valuation (beginning on January 1, 2012). The most significant are identified below.

- Compared to the prior valuation, the ultimate age-adjusted disability incidence rates increased by 2 percent for males and 5 percent for females. Inclusion of these changes to disability incidence rates projections increased the number of disability beneficiaries.
- Projected earnings of new beneficiaries were made more consistent with projected economy-wide covered worker rates. This change led to increases in projected benefit levels for workers who become eligible for benefits in the future.
- Average benefit levels for retired-worker and disabled-worker beneficiaries were slightly increased for their first 2 years of benefit entitlement. The method for estimating these average benefit levels was changed to exclude beneficiaries who first start receiving benefits 2 or more years after their initial entitlement date, who tend to have lower benefits.

Inclusion of each of these methodological improvements and updates of program-specific data revisions decreases the present value of future net cashflows.

#### **Period Beginning January 1, 2010, and Ending January 1, 2011**

Several methodological improvements and updates of program-specific data are included in the current valuation (beginning on January 1, 2011). The most significant are identified below.

- Disabled worker mortality and termination rates were updated to reflect a more recent historical period. Inclusion of these updates decrease the present value of future net cashflows.
- The historical sample of new beneficiaries, which serves as the basis of average benefit levels, was updated from a 2006 sample to a 2007 sample. Inclusion of this update increases the present value of future net cashflows.
- Actual experience of the combined OASI and DI Trust Funds between January 1, 2010 and January 1, 2011 is incorporated in the current valuation and is slightly less than projected in the prior valuation.

### **Changes in Law or Policy**

#### **Period Beginning on January 1, 2011, and Ending January 1, 2012**

There were no legislative changes, included in the current valuation (beginning on January 1, 2012) and not in the prior valuation, that are projected to have a significant effect on the present value of the 75-year net cashflows.

**Period Beginning January 1, 2010 and Ending January 1, 2011**

There were no legislative changes, included in the current valuation (beginning on January 1, 2011) and not in the prior valuation, that are projected to have a significant effect on the present value of the 75-year net cashflows.

**Medicare**

All estimates relating to the Medicare program in the Statement of Changes in Social Insurance Amounts represent values that are incremental to the prior change. As an example, the present values shown for demographic assumptions, represent the additional effect that these assumptions have, once the effects from the change in the valuation period and projection base have been considered.

**Assumptions Used for the Components of the Changes for the Medicare Program**

The present values included in the Statement of Changes in Social Insurance Amounts are for the current and prior years and are based on various economic and demographic assumptions used for the intermediate assumptions in the Medicare Trustees Reports for these years. Table 1B summarizes these assumptions for the current year.

**Period Beginning on January 1, 2011, and Ending January 1, 2012**

Present values as of January 1, 2011, are calculated using interest rates from the intermediate assumptions of the 2011 Medicare Trustees Report. All other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated as a present value as of January 1, 2012. Estimates of the present value of changes in social insurance amounts due to changing the valuation period, projection base, demographic assumptions, and law are determined using the interest rates under the intermediate assumptions of the 2011 Medicare Trustees Report. Since interest rates are economic assumptions, the estimates of the present values of changes in economic assumptions are presented using the interest rates under the intermediate assumptions of the 2012 Medicare Trustees Report.

**Period Beginning on January 1, 2010, and Ending January 1, 2011**

Present values as of January 1, 2010, are calculated using interest rates from the intermediate assumptions of the 2010 Medicare Trustees Report. All other present values in this part of the Statement of Changes in Social Insurance Amounts are calculated as a present value as of January 1, 2011. Estimates of the present value of changes in social insurance amounts due to changing the valuation period, projection base, demographic assumptions, and law are determined using the interest rates under the intermediate assumptions of the 2010 Medicare Trustees Report. Since interest rates are economic assumptions, the estimates of the present values of changes in economic assumptions are presented using the interest rates under the intermediate assumptions of the 2011 Medicare Trustees Report.

**Changes in Valuation Period****Period Beginning on January 1, 2011, and Ending January 1, 2012**

The effect on the 75-year present values of changing the valuation period from the prior valuation period (2011-85) to the current valuation period (2012-86) is measured by using the assumptions for the prior valuation period and applying them, in the absence of any other changes, to the current valuation period. Changing the valuation period removes a small negative net cashflow for 2011 and replaces it with a much larger negative net cashflow for 2086. The present value of future net cashflow (including or excluding the combined Medicare Trust Fund assets at the start of the period) was therefore decreased (made more negative) when the 75-year valuation period changed from 2011-85 to 2012-86.

**Period Beginning on January 1, 2010, and Ending January 1, 2011**

The effect on the 75-year present values of changing the valuation period from the prior valuation period (2010-84) to the current valuation period (2011-85) is measured by using the assumptions for the prior valuation period and applying them, in the absence of any other changes, to the current valuation period. Changing the valuation period removes a small negative net cashflow for 2010 and replaces it with a much larger negative net cashflow for 2085. The present value of future net cashflow (including or excluding the combined Medicare Trust Fund assets at the start of the period) was therefore decreased (made more negative) when the 75-year valuation period changed from 2010-84 to 2011-85.

## Change in Projection Base

### Period Beginning January 1, 2011, and Ending January 1, 2012

Actual revenue and expenditures in 2011 were different than what was anticipated when the 2011 Medicare Trustee Report projections were prepared. Part A revenue was slightly higher than estimated and Part A expenditures were lower than anticipated, based on actual experience. Part B total revenue and expenditures were higher than estimated based on actual experience. For Part D, actual revenue and expenditures were both slightly lower than prior estimates. The net impact of the Part A, B, and D projection-base changes is an increase in the future net cashflow. Actual experience of the Medicare Trust Funds between January 1, 2011 and January 1, 2012 is incorporated in the current valuation and is slightly more than projected in the prior valuation.

### Period Beginning on January 1, 2010, and Ending January 1, 2011

Actual revenue and expenditures in 2010 were different than what was anticipated when the 2010 Medicare Trustees Report projections were prepared. Part A revenue was lower than estimated and Part A expenditures were higher than anticipated, due to the impacts of the economic recession. Part B total revenue and expenditures were lower than estimated based on actual experience. For Part D, actual revenue and expenditures were both slightly lower than prior estimates. The net impact of the Part A, B, and D projection-base changes is a slight decrease in the future net cashflow. Actual experience of the Medicare Trust Funds between January 1, 2010, and January 2011 is incorporated in the current valuation and is slightly more than projected in the prior valuation.

## Changes in Demographic Data, Assumptions, and Methods

### Period Beginning January 1, 2011, and Ending January 1, 2012

The demographic assumptions used in the Medicare projections are the same as those used for the OASDI and are prepared by the Office of the Chief Actuary at the SSA.

The ultimate demographic assumptions for the current valuation period are the same as those for the prior valuation period. However, the starting demographic values were changed.

- Preliminary birth rate data for 2009 and 2010 are lower than were expected in the prior valuation. During the period of transition to their ultimate values, the birth rates in the current valuation are generally lower than they were in the prior valuation.
- The current valuation incorporates final data on legal immigration levels for 2010. The levels are slightly lower than the estimates used in the prior valuation.
- Updated starting population levels and the interaction of these levels with the changes in the fertility and immigration assumptions result in higher ratios of retirement age population to working age population than in the prior valuation.

These changes have little impact on the Part A present values of future expenditures and revenue. However, since overall population projections are lower compared to the prior valuation, these changes lower the Part B and Part D present values of expenditures.

### Period Beginning January 1, 2010, and Ending January 1, 2011

The demographic assumptions used in the Medicare projections are the same as those used for the OASDI and are prepared by the Office of the Chief Actuary at the SSA.

The ultimate demographic assumptions for the current valuation period are the same as those for the prior valuation period. However, the starting demographic values were changed.

- The inclusion of final mortality data for 2007 results in lower starting death rates and faster near-term declines in death rates at older ages for the current valuation period. Revised historical estimates of net other immigration and final data on legal immigration for 2009 are also used in the current valuation. Based on estimates from the Department of Homeland Security for 2007 and 2008 and due to the weak U.S. economy since 2008, net other immigration levels for 2007-2010 are assumed negative for the current valuation period. These levels are significantly lower than the positive estimates used in the prior valuation period.
- Birth rates projected through 2026 are slightly lower in the current valuation; preliminary birth data for 2008 and 2009 was lower than was expected for the prior valuation.

These changes have little impact on the present values of future expenditures and revenue.



## Changes in Economic and Other Health Care Assumptions

### Period Beginning January 1, 2011, and Ending January 1, 2012

The economic assumptions used in the Medicare projections are the same as those used for the OASDI and are prepared by the Office of the Chief Actuary at the SSA.

The ultimate economic assumptions for the current valuation period are the same as those for the prior valuation period. However, the starting economic values and near-term economic growth rate assumptions were changed. The economic recovery has been slower than was assumed for the prior valuation period.

- For the current valuation period, HI taxable earnings are considerably lower for the starting year, 2011, than were projected for the prior valuation period. The projected level of taxable earnings grows more slowly through 2017 for the current valuation period.
- Price inflation in 2011 was higher than expected, with the cost-of-living adjustment in December 2011 being 2.9 percentage points higher than was assumed in the prior valuation.
- The real interest rate is projected to be lower over the first 10 years of the current valuation period.

Inclusion of each of these economic revisions decrease the present value of future net cashflow.

The health care assumptions are specific to the Medicare projections. The following health care assumptions were changed in the current valuation.

- Case mix growth assumptions for inpatient hospitals were lowered.
- Utilization rate and case mix increase assumptions for skilled nursing facilities and home health agencies were increased.
- Growth in hospice services were increased.
- Increase in average pre-ACA “baseline” growth rate from GDP+1 percent to GDP+1.4 percent to better account for the level of payment rate updates for Medicare (prior to the ACA) compared to private health insurance and other payers of health insurance in the U.S.
- Use of the “factors contributing to growth” model, developed by the Office of the Actuary at CMS, for year-by-year growth rate assumptions in long range.
- Lower assumed growth rate for prescription drug expenditures is the U.S. overall.
- Explicit projection of Part B services indexed by the CPI (e.g., Ambulatory Surgical Center, lab and DME services).

The net impact of these changes resulted in a decrease in the future net cashflow for total Medicare. For Part A, these changes resulted in an increase to the present value of expenditures and a very slight decrease to the present value of revenue, with an overall decrease on the future net cashflow. For Part B, these changes increased the present value of expenditures. On the other hand, the above-mentioned changes lowered the present value of expenditures for Part D.

### Period Beginning January 1, 2010, and Ending January 1, 2011

The economic assumptions used in the Medicare projections are the same as those used for OASDI and are prepared by the Office of the Chief Actuary at the SSA.

The ultimate economic assumptions for the current valuation period are the same as those for the prior valuation period. However, the starting economic values and near-term economic growth rate assumptions were changed. The economic recovery has been slower than was assumed for the prior valuation period.

- For the current valuation period, HI taxable earnings are considerably lower for the starting year, 2010, than were projected for the prior valuation period. The projected level of taxable earnings grows more slowly through 2017 for the current valuation period.
- Unemployment rates are slightly higher over the first few years of the projection for the current valuation period. The interest rates assumed in the short-range period are lower for the current valuation period.

Inclusion of each of these economic revisions decreases the present value of future net cashflow.

The health care assumptions are specific to the Medicare projections. The following health care assumptions were changed in the current valuation.

- Utilization rates for certain hospitals were lowered.
- Components of price updates for hospitals were increased.
- Components of price updates for home health agency services were lowered.
- Slightly lower residual assumptions for certain Part B services in the short-range period.
- Slight refinement in the Part B application of the ACA multifactor productivity adjustments in the long range period, which lowers expenditures.

- The utilization assumed for beneficiaries assumed to switch from Medicare Advantage to fee-for-service was lowered.
- The utilization assumed for beneficiaries assumed to switch from fee-for-service to Medicare Advantage was increased.
- Assumed utilization of skilled nursing facility and home health agency services was increased.
- Reduction in the projected growth in prescription drug spending in the U.S.

These changes had a net negative impact on the future net cashflow for total Medicare. For Part A, these changes resulted in a net increase to the present value of both revenue and expenditures, with an overall increase on the future net cashflow. For Part B, these changes resulted in a net increase to the present value of both revenue and expenditures with an overall decrease on the future net cashflow.

## Changes in Law or Policy

### Period Beginning January 1, 2011, and Ending January 1, 2012

Although Medicare legislation was enacted since the prior valuation date, many of the provisions have a negligible impact on the present value of the 75-year revenue, expenditures, and net cashflow. However, there were three specific provisions enacted that had a fairly substantial impact on the Medicare program. These include the sequestration of up to two percent of Medicare provider expenditures per fiscal year from fiscal year 2013 through fiscal year 2021, as required by the Budget Control Act of 2011, which reduces the present value of expenditures for Medicare; the extension of the 0 percent physician payment update through calendar year 2012 required by the Temporary Payroll Tax Cut Continuation Act of 2011 and the Middle Class Tax Relief and Job Creation Act of 2012, which slightly increases the present value of Part B expenditures; and the reduction in bad debt payments required by the Middle Class Tax Relief and Job Creation Act of 2012, which reduces the present value of Part A and Part B expenditures.

### Period Beginning January 1, 2010, and Ending January 1, 2011

Although Medicare legislation was enacted since the prior valuation date, most of the provisions have a negligible impact on the present value of the 75-year income, expenditures, and net cashflow. However, the enacted changes to the physician payment update very slightly increased the present value of expenditures, and decreased the 75-year present value of future net cashflow.

## Railroad Retirement

The largest change in the open group measure of the Railroad Retirement social insurance program is due to changes in economic data and assumptions. Selected economic assumptions were updated in 2012 along with the following other components of changes in the open group measure.

## Changes in Valuation Period

### Period Beginning January 1, 2011, and Ending January 1, 2012

There were no changes in this valuation period.

### Period Beginning January 1, 2010, and Ending January 1, 2011

The change in the valuation period (from 2010-2084 to 2011-2085) had a minimal effect on the social insurance open group measure.

## Changes in Demographic Data and Assumptions

### Period Beginning January 1, 2011, and Ending January 1, 2012

Some demographic assumptions, such as the Annuitants Mortality Table, the Disabled Mortality Table for Annuitants with Disability Freeze, The Disabled Mortality Table for Annuitants without Disability Freeze, the Active Service Mortality Table, the Spouse Total Termination Table, the probability of a spouse, the rates of immediate age retirement, the rates of immediate disability retirement, the rates of eligibility for disability freeze, the rates of final withdrawal, service months, salary scales, and family characteristics, were changed between the Statement of Social Insurance as of January 1, 2011 and the Statement of Social Insurance as of January 1, 2012.

These changes and the changes in demographic data had a relatively small effect (about 0.3 billion) on the open group measure between January 1, 2011 and January 1, 2012.

**Period Beginning January 1, 2010, and Ending January 1, 2011**

Demographic assumptions were not changed between 2010 and 2011. Changes in demographic data had a minimal effect (less than 0.1 billion) on the open group measure between January 1, 2010 and January 1, 2011.

**Changes in Economic Data and Assumptions****Period Beginning January 1, 2011, and Ending January 1, 2012**

Both select and ultimate economic assumptions were changed between January 1, 2011, and January 1, 2012. The actual COLA of 3.6 percent was used for 2012 in place of the 3.0 percent COLA assumed for 2012 in the prior year's report. Assumed COLAs of 2.0 percent in 2013, 2.4 percent in 2014, and 2.8 percent in 2015 and thereafter were used rather than the 3.0 percent COLA assumed in the prior year's report. A wage increase rate of 3.5 percent was used for 2011 rather than the assumed 4 percent wage increase rate used for 2011 in the prior year's report. A wage increase rate of 3.8 percent was used for 2012 and thereafter rather than the 4 percent wage increase rate used in the prior year's report. Also, the actual 2011 investment return of (1.6 percent) was lower than the assumed 7.5 percent investment rate used for 2011 in the prior year's report. An assumed investment return of 7 percent was used for 2012 and all subsequent years rather than the 7.5 percent rate used in the prior year's report. Economic data and assumptions had the greatest effect on the open group measure, resulting in a change of about \$2.2 billion from January 1, 2011 to January 1, 2012.

**Period Beginning January 1, 2010, and Ending January 1, 2011**

Ultimate economic assumptions were not changed between the Statement of Social Insurances as of January 1, 2010, and the Statement of Social Insurance as of January 1, 2011, but the select economic assumptions were. The actual COLA of 0.0 percent was used for 2011 in place of the 0.5 percent COLA assumed for 2011 in the prior year's report. A wage increase rate of 2.4 percent was used for 2010 rather than the assumed 4 percent wage increase rate used for 2010 in the prior year's report. Also, the actual 2010 investment return of 14.4 percent was higher than the assumed 7.5 percent investment rate used for 2010 in the prior year's report. Economic data and assumptions for Cost of Living Adjustments, wage increase rate, and investment return were updated in 2012 and had the greatest effect on the open group measure.

**Changes in Methodology and Programmatic Data****Period Beginning January 1, 2011, and Ending January 1, 2012**

There were no changes in methodology and programmatic data.

**Period Beginning January 1, 2010, and Ending January 1, 2011**

There were no changes in methodology and programmatic data.

**Changes in Law or Policy****Period Beginning January 1, 2011, and Ending January 1, 2012**

There were no changes in law or policy.

**Period Beginning January 1, 2010, and Ending January 1, 2011**

There were no changes in law or policy.

**Black Lung**

The significant assumptions used in the projections of the Black Lung social insurance program presented in the Statement of Social Insurance are the number of beneficiaries, life expectancy, coal excise tax revenue estimates, the tax rate structure, Federal civilian pay raises and medical cost inflation. These assumptions also affect the amounts reported on the Statement of Changes in Social Insurance Amounts.

During fiscal year 2012, the decrease in the open group measure was primarily due to changes in the assumptions about coal excise tax revenues and changes in the assumptions about beneficiaries, including cost (not associated with medical inflation or Federal civilian pay raises), number, type, age, and life expectancy, which were

offset in part due to the change in the assumption about the interest rate that was used to discount the cash flows from 3.375 percent to 2.75 percent. For fiscal year 2012, the coal excise tax revenue projections were revised to reflect current year experience and a decrease in future collections. The assumptions about the beneficiaries were revised to reflect current year experience and an increase in future costs. The interest rate was revised to reflect the Treasury rate at the start of the projection period.

During fiscal year 2011, the decrease in the open and closed group measure was primarily due to changes in the assumptions about coal excise tax revenues, offset in part due to the changes in the assumptions about beneficiaries, including costs (not associated with medical inflation or Federal civilian pay raises), number, type, age, and life expectancy and the change in the assumption about the interest rate that was used to discount the cash flows from 3.75 percent to 3.375 percent. The coal excise tax revenue projections were revised to reflect the fiscal year 2011 experience and a decrease in future collections. The assumptions about the beneficiaries were revised to reflect the fiscal year 2011 experience and a decrease in future costs. The interest rate was revised to reflect the Treasury rate at the start of the projection period.

## Note 27. Stewardship Land and Heritage Assets

Stewardship land is federally-owned land that is set aside for the use and enjoyment of present and future generations, and land on which military bases are located. Except for military bases, this land is not used or held for use in general Government operations. Stewardship land is land that the Government does not expect to use to meet its obligations, unlike the assets listed in the Balance Sheets. Stewardship land is measured in non-financial units such as acres of land and lakes, and a number of National Parks and National Marine Sanctuaries. Examples of stewardship land include national parks, national forests, wilderness areas, and land used to enhance ecosystems to encourage animal and plant species, and to conserve nature. This category excludes lands administered by the Bureau of Indian Affairs and held in trust.

The majority of public lands that are under the management of DOI were acquired by the Government during the first century of the Nation's existence between 1781 and 1867.

Stewardship lands are used and managed in accordance with the statutes authorizing their acquisition or directing their use and management. Additional detailed information concerning stewardship land, such as agency stewardship policies, physical units by major categories, and the condition of stewardship land, can be obtained from the financial statements of DOI, DOC, DOD, and USDA.

Heritage assets are Government-owned assets that have one or more of the following characteristics:

- Historical or natural significance.
- Cultural, educational, or artistic importance.
- Significant architectural characteristics.

The cost of heritage assets often is not determinable or relevant to their significance. Like stewardship land, the Government does not expect to use these assets to meet its obligations. The most relevant information about heritage assets is non-financial. The public entrusts the Government with these assets and holds it accountable for their preservation. Examples of heritage assets include the Mount Rushmore National Memorial and Yosemite National Park. Other examples of heritage assets include the Declaration of Independence, the U.S. Constitution, and the Bill of Rights preserved by the National Archives. Also included are national monuments/structures such as the Vietnam Veterans Memorial, the Jefferson Memorial, and the Washington Monument, as well as the Library of Congress. Many other sites such as battlefields, historic structures, and national historic landmarks are placed in this category, as well.

Many laws and regulations govern the preservation and management of heritage assets. Established policies by individual Federal agencies for heritage assets ensure the proper care and handling of the assets under their control and preserve these assets for the benefit of the American public.

Some heritage assets are used both to remind us of our heritage and for day-to-day operations. These assets are referred to as multi-use heritage assets. One typical example is the White House. The cost of acquisition, betterment or reconstruction of all multi-use heritage assets is capitalized as general PP&E and is depreciated.

The Government classifies heritage assets into two broad categories: collection type and non-collection type. Collection type heritage assets include objects gathered and maintained for museum and library collections. Non-collection type heritage assets include national wilderness areas, wild and scenic rivers, natural landmarks, forests, grasslands, historic places and structures, memorials and monuments, buildings, national cemeteries, and archeological sites.

The discussion of the Government's heritage assets is not all-inclusive. Rather, it highlights significant heritage assets reported by Federal agencies. Please refer to the individual financial statements of the DOC, VA, State, DOD, National Archives and Records Administration, and Web sites for the Library of Congress (<http://www.loc.gov/index.html>), the Smithsonian Institution (<http://www.si.edu>), and the Architect of the Capitol (<http://aoc.gov>) for additional information on multi-use heritage assets, agency stewardship policies, and physical units by major categories and conditions.

## Note 28. Subsequent Events

### Statutory Debt Limit

As of September 30, 2012, debt subject to the statutory debt limit was \$16,027.0 billion, as stated in Note 14—Federal Debt Securities Held by the Public and Accrued Interest. As of September 30, 2012, and the issuance date of this *Financial Report*, the statutory debt limit was \$16,394.0 billion per Public Law 112-25. On December 26, 2012, the Secretary of the Treasury notified the Congress that the statutory debt limit would be reached on December 31, 2012. On December 31, 2012, Treasury began to depart from its normal debt management procedures and invoke legal authorities to avoid exceeding the statutory debt limit. As of the issuance date of this *Financial Report*, the statutory debt limit had not been increased.

### Statement of Social Insurance-Medicare

HHS considered the financial impact of both the reductions in Medicare payment rates for physician services and the budget sequestration, which was then expected to take effect, respectively, on January 1, 2013, and January 2, 2013, when preparing the fiscal year 2012 SOSI for Medicare. For policy changes enacted after the end of the fiscal year, but prior to the issuance of the financial statements, the financial statements should disclose the nature of the policy changes and, if known, the estimated effect on the projections related to the Statements of Social Insurance. The American Taxpayer Relief Act of 2012, enacted on January 2, 2013, included certain provisions affecting Medicare. As of the issuance of the *Financial Report*, the full financial effects of this Act on the Medicare SOSI projections are not known.

### Updates to Troubled Asset Relief Program (TARP) Investments

#### American International Group, Inc.

During December 2012, Treasury sold the remaining 154 million shares of AIG common stock held by Treasury under TARP at a share price of \$32.50. The sale of the AIG common stock resulted in proceeds of \$5.0 billion to Treasury under TARP.

#### General Motors

During December 2012, Treasury sold 200 million shares of GM common stock held by Treasury under TARP at a share price of \$27.50 per share, which resulted in proceeds of \$5.5 billion to Treasury under TARP.

See Note 5—Troubled Asset Relief Program (TARP)—Direct Loans and Equity Investments, Net for further information on TARP investments related to AIG and GM.

### Sale of Non-TARP Investments in AIG

During December 2012, Treasury sold all remaining 80 million shares of AIG common stock held by the General Fund at a share price of \$32.50 per share. The sale of the AIG common stock resulted in proceeds of \$2.6 billion to the General Fund. See Note 6—Non-TARP Investments in American International Group, Inc. for further information on the non-TARP investments in AIG.

## **Hurricane Sandy**

In late October 2012, Hurricane Sandy made landfall in the mid-Atlantic region of the United States, impacting the physical landscape, the people and the region's economy. As a result of the storm, the Government launched various response and recovery efforts, including power restoration, provisioning of food, fuel shelter, and security, reestablishing connectivity, and flood level and damage (e.g., erosion) assessments. The Government is still in the process of evaluating the impact of this storm and is unable to quantify damages at this time related to emergency relief assistance to the impacted states.

## **Emergency Unemployment Compensation Benefits**

Subsequent to September 30, 2012, emergency unemployment compensation benefits, first authorized by the Supplemental Appropriations Act, 2008 and extended by the American Recovery and Reinvestment Act of 2009 and other authorizing legislation through January 2, 2013, were extended through January 1, 2014, by the American Taxpayer Relief Act of 2012.

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# United States Government Required Supplementary Information (Unaudited) For the Years Ended September 30, 2012, and 2011

## Fiscal Projections for the U.S. Government—Fiscal Year 2012

This section of the FR is prepared pursuant to Statement of Federal Financial Accounting Standard (SFFAS) 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*. It is intended to help readers assess whether future budgetary resources will be sufficient to sustain public services and to meet future obligations as they come due, and the extent to which federal benefits received by current taxpayers will be shifted to future taxpayers, assuming that the Federal Government's current policies for spending and taxation are continued. Such an assessment requires prospective information about receipts and spending, the resulting debt, and how these amounts relate to the economy. The assessment is also referred to as reporting on "fiscal sustainability." A sustainable policy, as defined in the following analysis, is one where the ratio of federal debt held by the public to GDP (the debt-to-GDP ratio) is ultimately stable or declining. This section of the FR does not assess the sustainability of State and local government fiscal policy.

The projections and analysis presented here are extrapolations based on an array of assumptions described in detail below. Among these is the assumption that current Federal policy will not change. This assumption is made so as to inform the question of whether current fiscal policy is sustainable and, if it is not sustainable, the magnitude of needed reforms to make it sustainable. The projections are therefore neither forecasts nor predictions. If policy changes are implemented, perhaps in response to projections like those presented here, then actual financial outcomes will of course be different than those projected.

This is the third year that this section has been included in the FR. The methods and assumptions underlying the projections are still evolving.

### Statement of Long Term Fiscal Projections

Table 1 on the following page presents 75-year projections of the Federal Government's receipts and non-interest spending<sup>1</sup> for both the fiscal year 2012 and fiscal year 2011 Reports. Receipt categories include individual income taxes, Social Security and Medicare payroll taxes, and all other receipts. On the spending side, the projections are broken down into: (1) discretionary spending that is funded through annual appropriations, such as spending for national security, and (2) mandatory (entitlement) spending that is generally financed with permanent or multi-year appropriations, such as spending for Social Security and Medicare. This year's projections for Social Security and Medicare are based on the same economic and demographic assumptions as are used for the 2012 Social Security and Medicare Trustees' Reports and the Statement of Social Insurance, while comparative information presented from last year's report is based on the 2011 Social Security and Medicare Trustees' Reports. Projections for the other categories are consistent with the economic and demographic assumptions used from the trustees' reports. The projections assume the continuance of current policy without change, which is different than current law in cases where lawmakers have in the past periodically changed the law in a predictable way. Current policy differences from current law are explained in the section entitled "Departures of Current Policy from Current Law".

<sup>1</sup> For the purposes of this analysis, spending is defined in terms of outlays. In the context of Federal budgeting, spending can either refer to budget authority—the authority to commit the government to spend an amount—or to outlays, which reflect actual payments made.

The projections in Table 1 are expressed in present value dollars, and as a percentage of the present value of GDP<sup>2</sup> as of September 20, 2012 and 2011. The present value of a future amount, for example, \$1 billion in October 2087, is the amount of money that if invested on September 30, 2012 in an account earning the government borrowing rate would have a value of \$1 billion in October 2087.<sup>3</sup> The present value of a receipt or expenditure category over 75 years is the sum of the annual present value amounts. When expressing a receipt or expenditure category over 75 years as a percent of GDP, the present value dollar amount is divided by the present value of GDP over 75 years. Measuring receipts and expenditures as a percentage of GDP is a useful indicator of the economy's capacity to sustain federal government programs. As is true for all past *Financial Reports*, the assumptions for GDP, interest rates, and other economic factors underlying this year's projections are the same assumptions that underlie the most recent Social Security and Medicare Trustees' Report projections. The use of discount factors consistent with the Social Security trustees' rate allows for consistent present value budget calculations over 75 years between this report and the trustees' reports. Present value calculations under higher and lower interest rate scenarios are presented in the "Alternative Scenarios" section.

<b>Table 1: Long-Term Fiscal Projections of Federal Receipts and Spending</b>						
	75-Year Present Values <sup>1</sup>					
	Dollars in Trillions			%GDP <sup>2</sup>		
	2012	2011	Change	2012	2011	Change
<b>Receipts:</b>						
Social Security Payroll Taxes .....	42.1	39.1	3.0	4.3	4.4	-0.1
Medicare Payroll Taxes .....	14.1	13.0	1.1	1.5	1.5	0.0
Individual Income Taxes .....	97.5	93.5	4.0	10.0	10.5	-0.5
Other Receipts .....	37.9	34.7	3.2	3.9	3.9	0.0
<b>Total Receipts .....</b>	<b>191.6</b>	<b>180.2</b>	<b>11.4</b>	<b>19.7</b>	<b>20.3</b>	<b>-0.5</b>
<b>Non-interest Spending:</b>						
Social Security .....	57.5	51.8	5.7	5.9	5.8	0.1
Medicare Part A <sup>3</sup> .....	22.7	17.6	5.0	2.2	2.0	0.2
Medicare Parts B&D <sup>4</sup> .....	22.2	21.1	1.1	2.4	2.4	0.0
Medicaid .....	26.1	24.0	2.2	2.7	2.7	0.0
Security Discretionary .....	30.4	28.7	1.7	3.1	3.2	-0.1
Non-security Discretionary .....	16.1	15.4	0.7	1.7	1.7	-0.1
Other Mandatory .....	33.2	28.1	5.1	3.4	3.2	0.3
<b>Total Non-interest Spending .....</b>	<b>208.2</b>	<b>186.7</b>	<b>21.5</b>	<b>21.4</b>	<b>21.0</b>	<b>0.5</b>
<b>Non-interest Spending less Receipts:</b>	16.5	6.4	10.1	1.7	0.7	1.0
<sup>1</sup> 75-year present value projections for 2012 are as of 9/30/2012 for the period FY 2013-2087; projections for 2011 are as of 9/30/2011 for the period FY 2012-2086. <sup>2</sup> The 75-year present value of nominal GDP, which drives the calculations above, is \$971.3 trillion starting in FY 2013, and was \$889.8 trillion starting in FY 2012. <sup>3</sup> Represents portions of Medicare supported by payroll taxes. <sup>4</sup> Represents portions of Medicare supported by general revenues. Consistent with the President's Budget, Parts B & D are presented net of premiums, and Part D also net of state contributions. NOTE: Totals may not equal the sum of components due to rounding.						

<sup>2</sup> GDP is a standard measure of the overall size of the economy and represents the total market value of all final goods and services produced domestically during a given period of time. The components of GDP are: private sector consumption and investment, government consumption and investment, and net exports (exports less imports). Equivalently, GDP is a measure of the gross income generated from domestic production over the same time period.

<sup>3</sup> Present values recognize that a dollar paid or collected in the future is worth less than a dollar today because a dollar today could be invested and earn interest. To calculate a present value, future amounts are thus reduced using an assumed interest rate, and those reduced amounts are summed.

The projections shown in Table 1 are made over a 75-year time frame, consistent with the time frame featured in the Social Security and Medicare trustees’ reports. However, these projections are for fiscal years starting on October 1, whereas the trustees’ reports feature calendar-year projections. This difference allows the projections to start from the actual budget results from fiscal years 2012 and 2011.

The overall 75-year present value net excess of non-interest spending over receipts expressed in Table 1 is \$16.5 trillion (1.7 percent of the 75-year present value of GDP) for the 2012 projections. This imbalance can be expressed in terms of funding sources. There is a surplus of receipts over spending of \$1.3 trillion or 0.1 percent of GDP among programs funded by the government’s general revenues, but an imbalance of \$17.9 trillion<sup>4</sup> or 1.8 percent of GDP among Social Security (OASDI) and Medicare Part A, which are funded by payroll taxes and which are not funded in any material respects by the government’s general revenues under current law.<sup>5,6</sup> By comparison, the 2011 projections showed that programs funded by the government’s general revenues had an excess of receipts over spending of \$6.0 trillion or 0.7 percent of GDP while the payroll tax funded programs had an imbalance of spending over receipts of \$12.4 trillion or 1.4 percent of GDP.

Table 2 breaks down the sources of the change in the projection of the 75-year present value imbalance of spending over receipts from last year. The difference is primarily due to the changes in model technical assumptions, such as (i) the inclusion of cost 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.

<b>Table 2: Components of Change (PV Dollars in Trillions)</b>	
<b>Non-Interest Spending Less Receipts: FY 2011 .....</b>	<b>6.4</b>
Components of Change:	
Change in Model Technical Assumptions .....	9.0
Change due to Updated Actuarial Reports .....	2.6
Change due to Updated Budget Data .....	-1.9
Change in Economic and Demographic Assumptions .....	0.9
Change in Reporting Period .....	-0.5
<b>Total .....</b>	<b>10.1</b>
<b>Non-Interest Spending Less Receipts: FY 2012.....</b>	<b>16.5</b>

<sup>4</sup> The 75-year present value earmarked imbalance of \$17.9 trillion is comprised of several line items from Table 1 – Social Security outlays net of Social Security Payroll Taxes (\$15.3 trillion) and Medicare Part A outlays net of Medicare Payroll Taxes (\$8.6 trillion) – as well as subcomponents of these programs not presented separately in the table. These subcomponents include Social Security and Medicare Part A administrative costs that are classified as non-security discretionary spending (\$0.6 trillion) and Social Security and Medicare Part A revenue other than payroll taxes: taxation of benefits (-\$3.0 trillion), Federal employer share (-\$1.2 trillion), and other income (-\$2.5 trillion).

<sup>5</sup> General fund transfers received by the OASDI trust fund, primarily in 2011 and 2012, to account for lost payroll taxes resulting from enactment of the temporary 2 percent reduction of the employee payroll taxes are not included in the 75-year present value of OASDI payroll taxes. Social Security and Medicare Part A expenditures can exceed payroll tax revenues in any given year to the extent that there are sufficient balances in the respective trust funds, balances that derive from past excesses of payroll tax revenues over expenditures and interest earned on those balances. When spending does exceed payroll tax revenues, as has occurred in every year since 2008 for Medicare Part A and 2010 for Social Security, the excess spending is financed from general revenues or borrowing. Under current law, benefits for Social Security and Medicare Part A can be paid only to the extent that there are sufficient balances in the respective trust funds. In order for the projections here to reflect the full size of these program’s commitments to future benefits, the projections assume that all scheduled benefits will be financed with borrowing to the extent necessary after the trust funds are exhausted.

<sup>6</sup> The fiscal imbalances reported in Table 1 are limited to future outlays and receipts. They do not include the initial level of publicly-held debt, which was \$11.3 trillion, and therefore they do not by themselves answer the question of how large fiscal reforms must be to make fiscal policy sustainable, or how those reforms divide between reforms to Social Security and Medicare Part A and to other programs. Other things equal, past cash flows (primarily surpluses) for Social Security and Medicare Part A reduced federal debt at the end of 2012 by \$3.0 trillion (the trust fund balances at that time); the contribution of other programs to federal debt at the end of 2012 was therefore \$14.3 trillion. Because the \$17.9 trillion imbalance between outlays and receipts over the next 75 years for Social Security and Medicare Part A does not take account of the Social Security and Medicare Part A trust fund balances, it overstates the magnitude of reforms necessary to make Social Security and Medicare Part A solvent over 75 years by \$3.0 trillion. The \$3.0 trillion combined Social Security and Medicare Part A trust fund balance represents a claim on future general revenues.

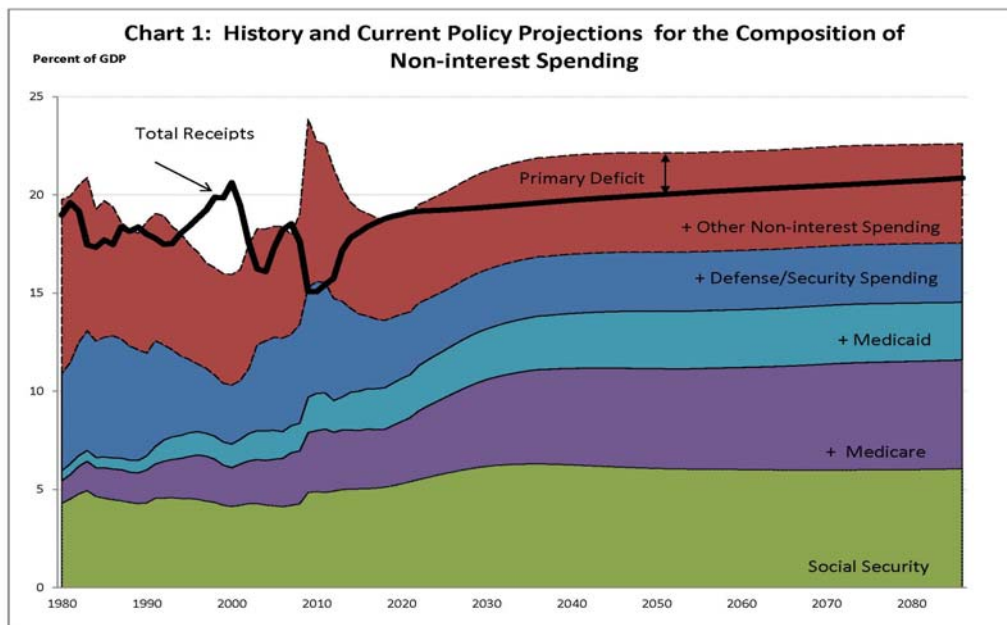
Another large source of change since 2011 was due to the 2012 actuarial reports for Social Security, Medicare, and the 2011 actuarial report for Medicaid that raised the 75-year present value imbalance by \$2.6 trillion.<sup>7</sup> Updated actual budget results for fiscal year 2012 lowered the projected 75-year present value imbalance by \$1.9 trillion. Also reflected in Table 2 are revised economic and demographic assumptions that raised the 75-year present value imbalance by \$0.9 trillion and the change in the reporting period from 2012-2086 to 2013-2087 that lowered the 75-year fiscal imbalance by \$0.5 trillion.

The projections presented in this report were finalized prior to the enactment of the American Taxpayer Relief Act of 2012 (ATRA) in January 2013. Among the important provisions included in that law are: (i) an extension of the 2001/2003 tax cuts for individuals with incomes up to \$400,000 and families with incomes up to \$450,000, but not for higher income individuals and families, (ii) permanent indexation of the Alternative Minimum Tax (AMT) for inflation, (iii) a 2-month delay in the implementation of automatic spending cuts called for in the Budget Control Act of 2011, and (iv) extension of a number of smaller tax measures. The only significant departure of the ATRA from the assumptions underlying the projections in this report is the expiration of the 2001/2003 tax cuts on high income earners. Updating the projections in this report to account for ATRA would therefore modestly reduce projected long term fiscal imbalances.

## The Sustainability of Fiscal Policy

One of the important purposes of the *Financial Report* is to help citizens and policymakers assess whether current fiscal policy is sustainable and, if it is not, the urgency and magnitude of policy reforms necessary to make it sustainable. A sustainable policy is one where the ratio of debt held by the public to GDP (the debt-to-GDP ratio) is ultimately stable or declining.

As is discussed below, the projections in this report indicate that current policy is not sustainable. If current policy is left unchanged, the ratio of debt to GDP is projected to rise by a little less than 2 percentage points from



<sup>7</sup> The majority of this increase is due to changes in the 2012 Medicare Trustees' Report, which projected larger imbalances in 2012 than in 2011 for a variety of reasons including assuming greater utilization of skilled nursing homes and home health agencies over the near term and faster growth in health costs per beneficiary over the long run.

2013 to 2015 and then to fall each year until 2020 by a total of a little more than 1 percentage point. Growth in debt resumes in 2020 over the remainder of the 75-year projection window and eventually reaches 395 percent in 2087. Moreover, if the trends that underlie the 75-year projections were to continue, the debt-to-GDP ratio would continue to rise into the indefinite future.

### Current Policy Projections for Primary Deficits

A key determinant of growth in the debt-to-GDP ratio and hence fiscal sustainability is the primary deficit-to-GDP ratio. The primary deficit is the difference between non-interest spending and receipts, and the primary deficit-to-GDP ratio is the primary deficit expressed as a percent of GDP. As shown in Chart 1, the primary deficit-to-GDP ratio grew rapidly in 2009 due to the financial crisis and the recession and the policies pursued to combat both. 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 spending reductions called for in the Budget Control Act of 2011 (BCA) take effect and the economy recovers, reaching primary balance 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 is expected to cause the primary balance to steadily deteriorate and reach 2.3 percent of GDP in 2039. After 2039, the projected primary deficit-to-GDP ratio slowly declines to 1.7 percent of GDP in 2087 as the impact of the baby boom generation retiring dissipates.

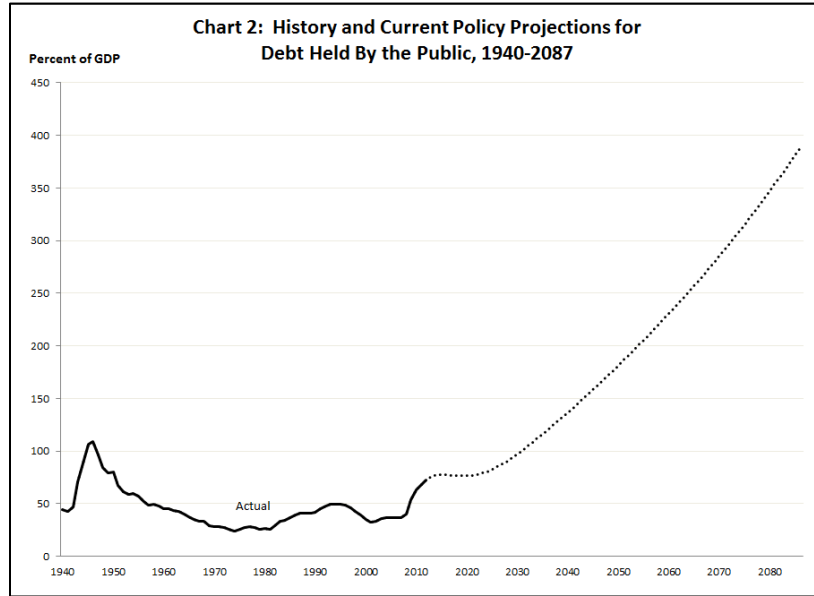
The revenue share of GDP fell substantially in 2009 and 2010 and remained low in 2011 and 2012 because of the recession and tax reductions enacted as part of the 2009 American Recovery and Reinvestment Act (ARRA) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The share is projected to return to near its long-run average as the economy recovers. After the economy has fully recovered around 2019, 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.<sup>8</sup> 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.

On the spending side, 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 and 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 increases are principally due to faster growth in Medicare, Medicaid, and Social Security spending (see Chart 1). 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 ACA significantly affects projected spending for both Medicare and Medicaid. That reform expands health insurance coverage, includes many measures designed to reduce health care cost growth, and reduces the annual increases in Medicare payment rates. On net, the ACA is projected to substantially reduce federal expenditures over the next 75 years. The Medicare spending projections in Table 1 are based on the 2012 Medicare Trustees' Report's current law projections, and those projections show a substantial slowdown in Medicare cost growth. The projections assume that Medicaid cost per unit of service grows at the same rate as Medicare cost growth per unit of service, so the ACA is also estimated to substantially slow Medicaid cost growth. These projections are subject to much uncertainty about the effectiveness of the ACA's provisions to reduce health care cost growth. Even if those provisions work as intended and as assumed in this projection, Chart 1 shows that there is still a persistent gap between projected receipts and projected total non-interest spending.

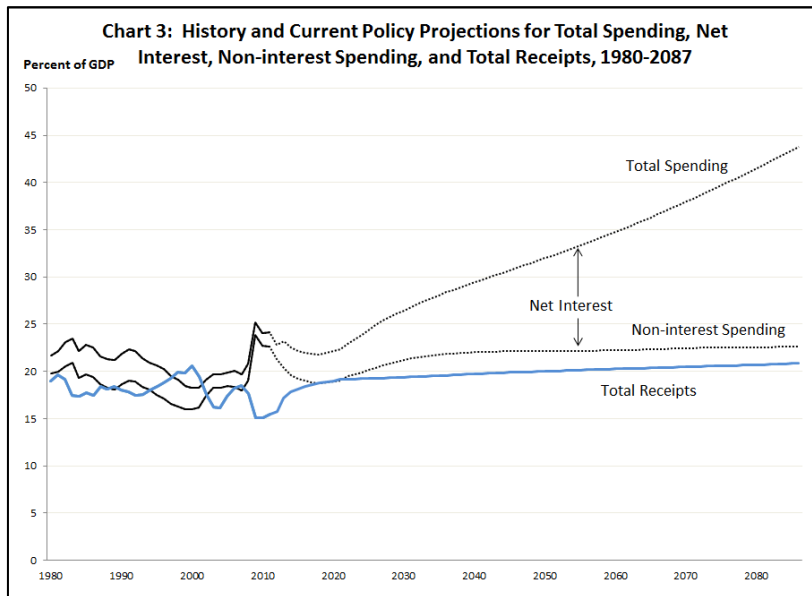
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<sup>8</sup> Projected revenues also account for increases (as a share of GDP) in employer-sponsored health insurance costs, which are tax exempt.



### Current Policy Projections for Debt and Interest Payments

The primary deficit projections in Chart 1, along with projections for interest rates and GDP, determine the projections for the debt-to-GDP ratio that are shown in Chart 2. 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. The continuous rise of the debt-to-GDP ratio indicates that current policy is unsustainable.



The change in debt held by the public from one year to the next is approximately equal to the unified budget deficit, the difference between total spending and total receipts.<sup>9</sup> Total spending is non-interest spending plus interest spending. Chart 3 shows that the rapid rise in total spending and the unified deficit is almost entirely due to projected interest payments on the debt. As a percent of GDP, interest spending was 1.4 percent in 2012, and under current policy is projected to reach 5 percent in 2029 and 21 percent in 2087.

Another way of viewing the deterioration in the financial outlook in this year's report relative to last year's report documented in Table 2 is in terms of the projected debt-to-GDP ratio in 2086. This ratio is projected to reach 388 percent in this year's report, which compares with 287 percent projected in last year's report.

**The Fiscal Gap**

The fiscal gap measures how much the primary surplus (receipts less non-interest spending) must increase in order for fiscal policy to achieve a target debt-to-GDP ratio in a particular future year. In these projections, the fiscal gap is estimated over a 75-year period, from 2013 to 2087, and the target debt-to-GDP ratio is equal to the ratio at the beginning of the projection period, in this case the debt-to-GDP ratio at the end of fiscal year 2012 (73 percent of GDP).

Table 3 reports that the 75-year fiscal gap under current policy is estimated at 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. As noted in Table 1, the difference between projected programmatic (non-interest) spending and receipts is 1.7 percent of GDP. However, eliminating this primary deficit of 1.7 percent of GDP is not sufficient to stabilize the debt-to-GDP ratio. Because interest rates are assumed to exceed the growth rate of GDP, reaching primary balance would leave debt rising relative to GDP. In order to fully close the fiscal gap, annual primary surpluses over the next 75 years must average 1.0 percent of GDP.

**The Cost of Delay in Closing the 75-Year Fiscal Gap**

The longer policy action to close the fiscal gap is delayed, the larger the post-reform primary surpluses must be to stabilize the debt-to-GDP ratio by the end of the 75 year period. Varying the years in which reforms are initiated while holding constant the ultimate target ratio of debt to GDP helps to illustrate the cost of delaying policy changes that close the fiscal gap. The reforms considered here increase the primary surplus relative to current policy by a fixed percent of GDP starting in the reform year. Three such policies are considered, each one beginning in a different year. The analysis shows that the longer policy action is delayed, the larger the post-reform primary surplus must be to bring the debt-to-GDP ratio to 73 percent of GDP in 2087. Future generations are harmed by policy delay because delay necessitates higher primary surpluses during their lifetimes, and those higher primary surpluses must be achieved through some combination of lower government benefits and higher taxes.

Table 3	
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.	

As previously shown in Chart 1, under current policy, primary deficits occur in nearly every year of the projection period. Table 3 shows primary surplus changes necessary to make the debt-to-GDP ratio in 2087 equal to its level in 2012 under each of the three policies. If reform begins in 2013, then it is sufficient to raise the primary surplus share of GDP by 2.7 percentage points in every year between 2013 and 2087 in order to have a debt-to-GDP ratio in 2087 equal to the level in 2012. This raises the average 2013-2087 primary surplus-to-GDP ratio from -1.7 percent to +1.0 percent.

<sup>9</sup> Debt held by the public is also affected by certain transactions not included in the unified budget deficit, such as changes in Treasury's cash balances and the nonbudgetary activity of Federal credit financing accounts. These transactions are assumed to hold constant at about 0.6 percent of present value GDP.

In contrast to a reform that begins immediately, if reform is begun in 2023 or 2033, the primary surplus must be raised by 3.2 percent and 4.1 percent of GDP, respectively, in order to reach a debt-to-GDP ratio in 2087 equal to the level in 2012. The difference between the primary surplus increase necessary if reform begins in 2023 and 2033 (3.2 and 4.1 percent of GDP, respectively) rather than in 2013 (2.7 percent of GDP) is a measure of the additional burden policy delay would impose on future generations. The costs of delay are due to increases in the debt-to-GDP ratio between 2012 and the year reform is initiated, which in turn increase the amount of interest that must be covered with the primary surplus. Delaying reform increases the cost of reaching the target debt-to-GDP ratio even if the target year is extended beyond 2087, since the starting debt-to-GDP ratio will be higher.

These estimates likely understate the cost of delay because they assume interest rates will not rise as the debt-to-GDP ratio grows. If a higher debt-to-GDP ratio causes the government borrowing rate to rise, making it more costly for the government to service its debt and simultaneously slowing private investment, the primary surplus required to return the debt-to-GDP ratio to its 2012 level will also increase. This dynamic may accelerate with higher ratios of debt to GDP, potentially leading to the point where there may be no feasible level of taxes and spending that would reduce the debt-to-GDP ratio to its 2012 level. The potential impact of changes in interest rates is explored in the “Alternative Scenarios” section.

### ***Assumptions Used and Relationship to Other Financial Statements***

A fundamental assumption underlying the projections is that current Federal policy—as defined below—does not change. The projections are therefore neither forecasts nor predictions. If policy changes are enacted, perhaps in response to projections like those presented here, then actual fiscal outcomes will of course be different than those projected.

Even if policy does not change, actual expenditures and receipts could differ materially from those projected here. This is because the long-range projections are inherently uncertain and because simplifying assumptions are made. One key simplifying assumption, for example, is that interest rates paid on public debt remain unchanged, regardless of the amount of debt outstanding. To the contrary, it is likely that future interest rates would increase if the debt rises as shown in these projections. To help illustrate this uncertainty, present value calculations under higher and lower interest rate scenarios are presented in the “Alternative Scenarios” section.

The projections in this section focus on future cash flows, and do not reflect either the accrual basis or the modified-cash basis of accounting. These cash-based projections reflect receipts or spending at the time cash is received or when a payment is made by the Government. In contrast, accrual-based projections would reflect amounts in the time period in which income is earned or when an expense is incurred. The cash basis accounting underlying this section is consistent with methods used to prepare the SOSI and the generally cash-based Federal budget.

The following bullets summarize the assumptions used for the key categories of receipts and spending presented in Table 1 and in the related analysis:

- **Social Security:** Projected Social Security (OASDI) spending is net of administrative expenses, which are classified as discretionary spending, and is based on the projected expenditures in the 2012 Social Security Trustees’ Report for benefits and the RRB-SSA-CMS Financial Interchange. The projections of Social Security payroll taxes and future Social Security spending begin with actual budget data for fiscal year 2012. The projected growth rates for future spending and payroll taxes are equal to the spending and tax growth rate projections underlying the latest 2012 Social Security Trustees’ Report.
- **Medicare:** Projected Medicare spending is also net of administrative expenses and is based on projected incurred expenditures from the 2012 Medicare Trustees Report. However, some adjustments to the Trustees Report projections are made. Medicare Part B and D premiums, as well as State contributions to Part D, are subtracted from gross spending in measuring Part B and Part D outlays, just as they are subtracted from gross cost to yield net cost in the financial statements.<sup>10</sup> Here, as in the Federal budget, premiums are treated as “negative spending” rather than receipts since they represent payment for a service rather than payments obtained through the Government’s sovereign power to tax. This is similar to the financial statement treatment of premiums as “earned” revenue as distinct from all other sources of revenue, such as taxes. The projections start with actual fiscal year 2012 Medicare spending and assume spending growth accords with the growth rates projected in the Medicare Trustees Report. Medicare Part A payroll taxes are projected similarly. As discussed in Note 26, there is uncertainty about whether the reductions in health

<sup>10</sup> Medicare Part B and D premiums and State contributions to Part D are subtracted from the Part B and D spending displayed in Table 1. The total 75-year present value of these subtractions is \$7.8 trillion, or 0.8 percent of GDP.



care cost growth projected in the Medicare Trustees Report will be fully achieved. Note 26 illustrates this uncertainty by considering Medicare cost growth assumptions under varying policy assumptions.

- Medicaid:** The Medicaid spending projections start with the projections from the *2011 Actuarial Report on the Financial Outlook for Medicaid* prepared by the Office of the Actuary, CMS.<sup>11</sup> Those projections end in 2020. After 2020, it is assumed that Medicaid benefits grow at the same rate per beneficiary as do Medicare benefits, as is consistent with the experience since 1987. Between 1987 and 2011, the average annual growth rate of outlays per beneficiary for Medicaid and Medicare were within 0.2 percentage points of each other. The projections through 2020 account for the effects of the ACA to reflect higher future enrollment, as calculated by CMS, and reflect other adjustments to align the base projections with the latest budget data. The Medicaid projections do not reflect any change in the interpretation of the ACA due to the June 2012 Supreme Court ruling on the law, as the CMS actuarial report predates the ruling and its estimated impact was still under development by CMS when the current projections were finalized. Medicaid beneficiaries are expected to grow at the assumed rate of population growth after the end of the projection window in the Medicaid actuarial report.
- Other Mandatory Spending:** Other mandatory spending is projected in two steps. First, spending prior to the automatic spending cuts called for by the BCA is projected and, second, the effect of the BCA is projected. With regard to pre-BCA spending: (a) Current mandatory spending components that are judged permanent under current policy are assumed to increase by the rate of growth in nominal GDP starting in 2013, implying that such spending will remain constant as a percentage of GDP; (b) Special assumptions are made for temporary mandatory spending authorized by ARRA and other stabilization measures, including temporary expansions in unemployment insurance benefits, TARP, the purchase of government sponsored enterprise (GSE) preferred stock, and higher net spending for the FDIC—the 75-year present value of projected spending for this category totals \$0.1 trillion; and (c) Projected new spending for insurance exchange subsidies starting in 2014 follows the most recent Mid-Session Review projections until 2022, and then grows in accordance with growth in the projected non-elderly population and growth in health care costs as projected for the Medicare program.
- Discretionary Spending:** Through 2021, discretionary spending other than for Overseas Contingency Operations (OCO) is dictated by the spending caps and automatic spending cuts called for by the BCA. After 2021, this spending is assumed to grow at the same rate as nominal GDP, and thus plateaus at a long-term level of 5.0 percent of GDP. Projected OCO spending steadily declines and is fully phased out by 2026. The 75-year present value of OCO spending totals \$0.5 trillion, or under half of one tenth of a percent of present value GDP, and the present value of the BCA automatic spending cuts is -\$0.4 trillion
- Receipts (Other than Social Security and Medicare):** It is assumed that individual income taxes will equal the same share of wages and salaries as in the Administration's latest Mid-Session Review adjusted baseline projection. That baseline follows all of the assumptions underlying current policy without change in these projections of current policy without change, and incorporates the effects of the economic recovery and bracket creep. After reaching about 20.5 percent of wages and salaries in 2022, individual income taxes increase gradually to almost 27 percent of wages and salaries in 2087 as real taxable incomes rise over time and an increasing share of total income is taxed in the higher tax brackets. The ratio of all other receipts combined to GDP is projected to rise over the next several years as the economy recovers, and to then level off at 4 percent of GDP, the historical average between 1979 and 2010.
- Interest Spending:** Interest spending is determined by projected interest rates and the level of outstanding debt held by the public. The long-run interest rate assumptions convert those in the 2012 Social Security Trustees Report<sup>12</sup> to a fiscal year basis. The average interest rate over the projection period is 5.5 percent. These rates are also used to convert future cash flows to present values as of the start of fiscal year 2013.

## Departures of Current Policy from Current Law

The long-term fiscal projections are made on the basis of current Federal policy, which in some cases is different from current law. The projections are made without regard to the statutory limit on outstanding Federal debt. In addition, the projections also assume continued discretionary appropriations throughout the projection period, the continued payment of Social Security and Medicare benefits beyond the projected point of trust fund

<sup>11</sup> Christopher J. Truffer, John D. Klemm, Christian J. Wolfe, and Kathryn E. Rennie *2011 Actuarial Report on the Financial Condition for Medicaid*, Office of the Actuary, Centers for Medicare and Medicaid Services, United States Department of Health and Human Services.

<sup>12</sup> As indicated in the more detailed discussion of Social Insurance in Note 26 to the financial statements.

exhaustion, extension of the 2001/2003 tax cuts, indexing of the current thresholds for the AMT, and the reauthorization of many mandatory programs with expiration dates prior to the end of the 75-year projection period. As is true in the Medicare trustees' report and in the Statement of Social Insurance,<sup>13</sup> the projections assume reductions in Medicare physician fees will occur as scheduled under current law.

## Alternative Scenarios

The long-run outlook for the budget is extremely uncertain. This section illustrates this inherent uncertainty by presenting alternative scenarios that vary several key assumptions.

There are many dimensions to the projections for which reasonable variations could be considered. Some of the key issues concern long-run economic and demographic assumptions. The long-run fiscal gap is partly the result of demographic patterns that have emerged over the last 50 years with lower birth rates and reduced mortality. The population is aging rapidly and will continue to do so over the next several decades, which puts pressure on programs such as Social Security, Medicare, and Medicaid nursing care. A shift in projected fertility, mortality, or immigration rates could have important long-run effects on the projections. Higher than projected immigration, fertility, or mortality rates would improve the long-term fiscal outlook. Conversely, lower than projected immigration, fertility, or mortality rates would result in deterioration in the long-term fiscal outlook. The remainder of this section will focus on two important variables that can also impact fiscal projections: the growth rate of health care costs and interest rates.

### Effect of Changes in Health Care Cost Growth

One of the most important assumptions underlying the projections is the projected growth of health care costs. Enactment of the ACA in 2010 reduced the projected long-run growth rates of health care costs, but these growth rates are still highly uncertain. As an illustration of the dramatic effect of variations in health care cost growth rates, Table 4 shows the effect on the cost of closing the fiscal gap as well as delaying closure of the fiscal gap of per capita health care cost growth rates that are one percentage point higher or two percentage points higher than the growth rates in the base projection. If reform is initiated in 2013, eliminating the fiscal gap requires that the 2013-2087 primary surplus increase by an average of 2.7 percent of GDP in the base case, 5.6 percent of GDP if per capita health cost growth is 1 percentage point higher, and 8.7 percent of GDP if per capita health cost growth is 2 percentage points higher. The cost of delaying reform is also increased if health care cost growth is higher, due to the fact that debt accumulates more rapidly during the period of inaction. For example, the lower part of Table 4 shows that delaying reform initiation from 2013 to 2023 requires that 2023-2087 primary surpluses be higher by an average of 0.6 percent of GDP in the base case, 1.2 percent of GDP if per capita health cost growth is 1 percentage point higher, and 1.8 percent of GDP if per capita health cost growth is 2 percentage points higher. The dramatic deterioration of the long-run fiscal outlook caused by higher health care cost growth shows the critical importance of managing health care cost growth, including through effective implementation of the ACA.

<sup>13</sup> To prevent the reductions in Medicare physician fees that would have otherwise taken place, since 2003 Congress has repeatedly enacted statutes with temporary "physician fee relief" provisions, which increase health care expenditures. Since 2003, the majority of these statutes have also included other provisions that would reduce expenditures associated with Medicare or other types of health care ("health care cost savings provisions") The assumption here that future reductions in Medicare payments for physicians' services will occur as scheduled under current law has the same budgetary effect as the assumption that the reductions will be overridden by enactment of new temporary physician fee relief provisions but the resulting costs will be paid for through enactment of new health care cost savings provisions.

<b>Table 4</b>			
<b>Impact of Alternative Health Cost Scenarios on Cost of Delaying Fiscal Reform</b>			
<b>Scenario</b>	<b>Primary Surplus Increase (% of GDP) Starting in:</b>		
	<b>2013</b>	<b>2023</b>	<b>2033</b>
Base Case .....	2.7	3.2	4.1
1% pt. higher per person health cost growth.....	5.6	6.7	8.5
2% pt. higher per person health cost growth.....	8.7	10.5	13.2
	<b>Increments to Required Primary Surplus if Reform is Delayed From 2013 to:</b>		
		<b>2023</b>	<b>2033</b>
Base Case .....		0.6	1.4
1% pt. higher per person health cost growth.....		1.2	2.9
2% pt. higher per person health cost growth.....		1.8	4.5
NOTE: Increments may not equal the subtracted difference of the components due to rounding.			

**Effects of Changes in Interest Rates**

A higher debt-to-GDP ratio is likely to increase the interest rate on Government debt, making it more costly for the Government to service its debt. Table 5 displays the effect of several alternative scenarios using different nominal interest rates than assumed in the base case on the cost of closing the fiscal gap as well as delaying closure of the fiscal gap. If reform is initiated in 2013, eliminating the fiscal gap requires that the 2013-2087 primary surplus increase by an average of 2.7 percent of GDP in the base case, 2.9 percent of GDP if the interest rate is 0.5 percentage point higher in every year, and 3.2 percent of GDP if the interest rate is 1.0 percentage points higher in every year. The cost of delaying reform is also increased percent of GDP if the interest rate is 1.0 percentage points higher in every year. The cost of delaying reform is also increased if interest rates are higher, due to the fact that interest paid on debt accumulates more rapidly during the period of inaction. For example, the lower part of Table 5 shows that delaying reform initiation from 2013 to 2023 requires that 2023-2087 primary surpluses be higher by an average of 0.6 percent of GDP in the base case, 0.7 percent of GDP if the interest rate is 0.5 percentage point higher in every year, and 0.9 percent of GDP if the interest rate is 1.0 percentage points higher in every year. To show the effects of achieving primary balance and lowering long-term debt-to-GDP and interest rates, lowering nominal interest rates by one-half percentage point from the base projection starting in 2013 lowers the cost of reform over the three periods, to 2.4 percent of GDP per year starting in 2013, 2.8 percent per year starting in 2023, and 3.5 percent per year starting in 2033.

<b>Table 5</b>			
<b>Impact of Alternative Interest Rate Scenarios on Cost of Delaying Fiscal Reform</b>			
<b>Scenario</b>	<b>Primary Surplus Increase (% of GDP) Starting in:</b>		
	<b>2013</b>	<b>2023</b>	<b>2033</b>
Base Case: Average of 5.5 percent over 75 years .....	2.7	3.2	4.1
0.5 percent higher interest rate in each year.....	2.9	3.6	4.7
1.0 percent higher interest rate in each year.....	3.2	4.1	5.5
0.5 percent lower interest rate in each year .....	2.4	2.8	3.5
	<b>Increments to Required Primary Surplus if Reform is Delayed From 2013 to:</b>		
	<b>2023</b>	<b>2033</b>	
Base Case: Average of 5.5 percent over 75 years .....	0.6	1.4	
0.5 percent higher interest rate in each year.....	0.7	1.8	
1.0 percent higher interest rate in each year.....	0.9	2.3	
0.5 percent lower interest rate in each year .....	0.4	1.1	
NOTE: Increments may not equal the subtracted difference of the components due to rounding.			

Other key economic assumptions in this report include the future growth rate of real GDP, which itself depends on assumptions such as future growth in the labor force and labor productivity. Historically, U.S. labor productivity has increased at a rate of about 2 percent or more per year, but there have been periods when productivity grew less rapidly and other periods in which it grew faster. Productivity growth has averaged 2.5 percent per year over the last 15 years, which is above its long-run trend. In these projections, the rate of productivity growth is conservatively assumed to be somewhat below its long-run trend. It is unlikely that higher productivity growth will be sufficient to resolve the long-run budget problem. Faster growth will lead to higher wages, which will lead to more tax revenue in the near term, but these gains will be partly offset by higher payments for Social Security and other benefit programs for which benefits are tied to wages. Inflation is not a major factor in these calculations. Changes in the trend rate of inflation have offsetting effects on future revenues and future spending, so the budget effect is about neutral in the long run.

## Fiscal Projections in Context

The United States Government's debt as a percentage of GDP is relatively large compared with central government debt of other countries, but far from the largest among the countries in the Organization for Economic Co-operation and Development (OECD). Based on historical data as reported by the OECD for all of its 31 member countries, the debt-to-GDP ratio in 2009 ranged from 6 percent of GDP to 126 percent of GDP, with the United States in the higher echelon.<sup>14</sup> However, each country is different in how it finances its sovereign debt, how robustly its economy grows, how government responsibilities are shared between central and local governments, and how current policies compare with the past policies that determine the current level of debt, so there is a very imperfect relationship between the current level of central government debt and the sustainability of overall government

<sup>14</sup> Central Government Debt, OECD National Accounts Statistics (database) available at [http://www.oecd-ilibrary.org/finance-and-investment/total-central-government-debt-2010\\_20758294-2010-table1](http://www.oecd-ilibrary.org/finance-and-investment/total-central-government-debt-2010_20758294-2010-table1).

policy. Past accrual of debt is certainly important, but current policies and their implications for future debt accumulation are too.

Several countries do produce long-range fiscal projections, among them, Australia, New Zealand, Canada, the United Kingdom, Denmark, Sweden, Norway, and the Netherlands.<sup>15</sup> However, in addition to the reasons discussed above, comparisons are difficult because coverage and the time horizon over which projections are made vary across countries. The projection periods tend to be less than 75 years, and the projections are not always updated annually. Some of the countries have determined that their policies are sustainable in the long run, although the recent financial crisis will have worsened the near-term budget outlook in almost every country.

## Conclusion

The United States took a potentially significant step towards fiscal sustainability in 2010 by reforming its system of health insurance through enactment of the ACA. The legislated changes for Medicare, Medicaid, and other health coverage hold the prospect of lowering the long-term growth trend for health care costs and significantly reducing the long-term fiscal gap. Furthermore, enactment of the Budget Control Act in August 2011 placed limits on future discretionary spending and established a process to further reduce projected deficits by at least \$1.2 trillion from 2013 through 2021. But even with the new laws, the projections in this Report indicate that if policy remains unchanged the debt-to-GDP ratio will continually increase over the next 75 years and beyond, which implies current policies are not sustainable and must ultimately change. Subject to the important caveat that policy changes are not so abrupt that they slow the economic recovery, the sooner policies are put in place to avert these trends, the smaller are the revenue increases and/or spending decreases necessary to return the Government to a sustainable fiscal path.

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<sup>15</sup> The OECD released a policy brief in October 2009 (available at <http://www.oecd.org/dataoecd/40/26/43836144.pdf>) describing the efforts of different member countries to produce long-term fiscal projections.

## Social Insurance

The social insurance programs consisting of Social Security, Medicare, Railroad Retirement, and Black Lung were developed to provide income security and health care coverage to citizens under specific circumstances as a responsibility of the Government. Because taxpayers rely on these programs in their long-term planning, social insurance program information should indicate whether the current law provisions of the programs can be sustained, and more generally what effect they will likely have on the Government's financial condition. The resources needed to run these programs are raised through taxes and fees. Eligibility for benefits depends in part on earnings and time worked by the individuals. Social Security benefits are generally redistributed intentionally toward lower-wage workers (i.e., benefits are progressive). In addition, each social insurance program has a uniform set of entitling events and schedules that apply to all participants.

### Social Security and Medicare

#### Social Security

The OASI Trust Fund was established on January 1, 1940, as a separate account in the Treasury. The DI Trust Fund, another separate account in the Treasury, was established on August 1, 1956. OASI pays cash retirement benefits to eligible retirees and their eligible dependents and survivors, and the much smaller DI fund pays cash benefits to eligible individuals who are unable to work because of medical conditions and certain family members of such eligible individuals. Though the events that trigger benefit payments are quite different, both trust funds have the same earmarked financing structure: primarily payroll taxes and income taxes on benefits. All financial operations of the OASI and DI Programs are handled through these respective funds. The two funds are often referred to as the combined OASDI Trust Funds. At the end of calendar year 2011, OASDI benefits were paid to approximately 55 million beneficiaries.

The primary financing source for these two funds are taxes paid by workers, their employers, and individuals with self-employment income, based on work covered by the OASDI Program. Since 1990, employers and employees have each paid 6.2 percent of taxable earnings and the self-employed paid 12.4 percent of taxable earnings. However, in 2011 and 2012, payroll tax rates paid by employees and the self-employed were each reduced by 2 percentage points and the General Fund of the Treasury reimbursed the OASDI trust fund for the resulting reduction in payroll tax revenues. Payroll taxes are levied on wages and net earnings from self-employment up to a specified maximum annual amount, referred to as maximum taxable earnings (\$110,100 in 2012), that increases each year with economy-wide average wages.

Legislation passed in 1984 subjected up to half of OASDI benefits to tax and allocated the revenue to the OASDI Trust Funds. In 1993 legislation upped the potentially taxed portion of benefits to 85 percent and allocated the additional revenue to the Hospital Insurance Trust Fund.

#### Medicare

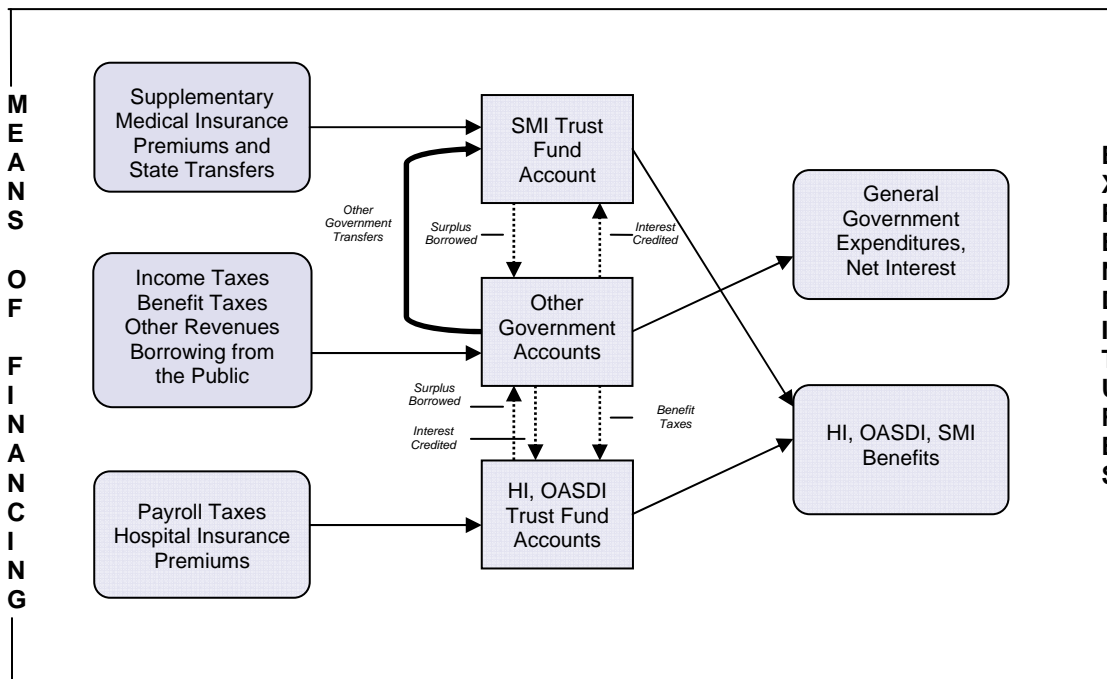
The Medicare Program, created in 1965, has two separate trust funds: the Hospital Insurance Trust Fund (HI, Medicare Part A) and the Supplementary Medical Insurance Trust Funds (SMI, Medicare Parts B and D<sup>1</sup>). HI pays for inpatient acute hospital services and major alternatives to hospitals (skilled nursing services, for example). SMI pays for hospital outpatient services, physician services, and assorted other services and products through the Part B account and for prescription drugs through the Part D account. Though the events that trigger benefit payments are similar, HI and SMI have different earmarked financing structures. Similar to OASDI, HI is financed primarily by payroll contributions. Currently, employers and employees each pay 1.45 percent of earnings, while self-employed workers pay 2.9 percent of their net earnings. Beginning in 2013, employees and self-employed individuals with earnings above certain thresholds will pay an additional HI tax of 0.9 percent on earnings above those thresholds. Other income to the HI Trust Fund includes a small amount of premium income from voluntary enrollees, a portion of the Federal income taxes that beneficiaries pay on Social Security benefits (as explained above), and interest

<sup>1</sup> Medicare legislation in 2003 created the new Part D account in the SMI Trust Fund to track the finances of a new prescription drug benefit that began in 2006. As in the case of Medicare Part B, approximately three-quarters of revenues to the Part D account will come from future transfers from the General Fund of the Treasury. Consequently, the nature of the relationship between the SMI Trust Fund and the Federal Budget described below is largely unaffected by the presence of the Part D account though the magnitude will be greater.

credited on Treasury securities held in the HI Trust Fund. As is explained in the next section, these Treasury securities and related interest have no effect on the consolidated statement of Governmentwide finances.

For SMI, transfers from the General Fund of the Treasury financed 75 percent and 74 percent of 2012 program costs for Parts B and D, respectively. Premiums paid by beneficiaries and, for Part D State transfers, financed the remainder of expenditures. With the introduction of Part D drug coverage, Medicaid is no longer the primary payer of drug benefits for beneficiaries dually eligible for Medicare and Medicaid. For those beneficiaries, States must pay the Part D account a portion of their estimated foregone drug costs for this population (referred to as State transfers). As with HI, interest received on Treasury securities held in the SMI Trust Fund is credited to the fund. These Treasury securities and related interest have no effect on the consolidated statement of Governmentwide finances. See Note 26—Social Insurance, for additional information on Medicare program financing.

**Figure 1  
Social Security, Medicare, and Governmentwide Finances**



**Social Security, Medicare, and Governmentwide Finances**

The current and future financial status of the separate Social Security and Medicare Trust Funds is the focus of the trustees’ reports, a focus that may appropriately be referred to as the “trust fund perspective.” In contrast, the Government primarily uses the *unified budget* concept as the framework for budgetary analysis and presentation. It represents a comprehensive display of all Federal activities, regardless of fund type or on- and off-budget status, and has a broader focus than the trust fund perspective that may appropriately be referred to as the “budget perspective” or the “Governmentwide perspective.” Social Security and Medicare are among the largest expenditure categories of the U.S. Federal budget. Together, they now account for more than a third of all Federal spending and the percentage is projected to rise dramatically for the reasons discussed below. This section describes in detail the important relationship between the trust fund perspective and the Governmentwide perspective.

Figure 1 is a simplified graphical depiction of the interaction of the Social Security and Medicare Trust Funds with the rest of the Federal budget.<sup>2</sup> The boxes on the left show sources of funding, those in the middle represent the trust funds and other Government accounts (of which the General Fund is a part) into which that funding flows, and the boxes on the right show simplified expenditure categories. The figure is intended to illustrate how the various sources of program revenue flow through the budget to beneficiaries. The general approach is to group revenues and expenditures that are linked specifically to Social Security and/or Medicare separately from those for other government programs.

Each of the trust funds has its own sources and types of revenue. With the exception of General Fund transfers to SMI, each of these revenue sources represents revenue from the public that are earmarked specifically for the respective trust fund and cannot be used for other purposes. In contrast, personal and corporate income taxes and other revenue go into the General Fund of the Treasury and are drawn down for any Government program for which Congress has approved spending.<sup>3</sup> The arrows from the boxes on the left represent the flow of the revenues into the trust funds and other Government accounts.

The heavy line between the top two boxes in the middle of Figure 1 represents intragovernmental transfers to the SMI Trust Fund from other Government accounts. The Medicare SMI Trust Fund is shown separately from the two Social Security trust funds (OASI and DI) and the Medicare HI Trust Fund to highlight the unique financing of SMI. SMI is currently only one of the programs that is funded through transfers from the General Fund of the Treasury, which is part of the other Government accounts (the Part D account also receives transfers from the States). The transfers finance roughly three-fourths of SMI Program expenses. The transfers are automatic; their size depends on how much the program requires, not on how much revenue comes into the Treasury. If General Fund revenues become insufficient to cover both the mandated transfer to SMI and expenditures on other general Government programs, Treasury would have to borrow to make up the difference. In the longer run, if transfers to SMI increase beyond growth in general revenues as shown below, they are projected to increase significantly in coming years—then Congress must either raise taxes, cut other Government spending, reduce SMI benefits, or borrow even more.

The dotted lines between the middle boxes of Figure 1 also represent intragovernmental transfers but those transfers arise in the form of “borrowing/lending” between the Government accounts. Interest credited to the trust funds arises when the excess of program income over expenses is loaned to the General Fund. The vertical lines labeled *Surplus Borrowed* represent these flows from the trust funds to the other Government accounts. These loans reduce the amount the General Fund has to borrow from the public to finance a deficit (or likewise increase the amount of debt paid off if there is a surplus). However, the General Fund has to credit interest on the loans from the trust fund programs, just as if it borrowed the money from the public. The credits lead to future obligations for the General Fund (which is part of the other Government accounts). These transactions are indicated in Figure 1 by the vertical arrows labeled *Interest Credited*. The credits increase trust fund income exactly as much as they increase credits (future obligations) in the General Fund. From the Governmentwide standpoint, at least in an accounting sense, these interest credits are a wash.

It is important to understand the additional implications of these loans from the trust funds to the other Government accounts. When the trust funds get the receipts that they loan to the General Fund, these receipts provide additional authority to spend on benefits and other program expenses. The General Fund, in turn, has taken on the obligation of paying interest on these loans every year and repaying the principal when trust fund income from other sources falls below expenditures.

How loans from the trust funds to the General Fund and later repayments of those loans affect tax income and expenditures of the General Fund is uncertain. Two extreme cases bracket the possibilities. At one extreme, each dollar the trust funds loan to the General Fund might reduce borrowing from the public by a dollar at the time the loan is extended, in which case the General Fund could repay all trust fund loans by borrowing from the public without raising the level of public debt above the level that would have occurred in the absence of the loans. At the other extreme, each dollar the trust funds loan to the General Fund might result in some combination of higher General Fund spending and lower General Fund revenues amounting to one dollar at the time the loans are extended, in which case General Fund loan repayments to the trust funds might initially be financed with borrowing from the public but must at some point be financed with a combination of higher general fund taxes and lower General Fund

<sup>2</sup> The Federal unified budget encompasses all Government financing and is synonymous with a Governmentwide perspective.

<sup>3</sup> Other programs also have dedicated revenues in the form of taxes and fees (and other forms of receipt) and there are a large number of earmarked trust funds in the Federal budget. Total trust fund receipts account for about 40 percent of total Government receipts with the Social Security and Medicare Trust Funds accounting for about two-thirds of trust fund receipts. For further discussion, see the report issued by the Government Accountability Office, *Federal Trust and Other Earmarked Funds*, GAO-01-199SP, January 2001. In the figure and the discussion that follows, all other programs, including these other earmarked trust fund programs, are grouped under “Other Government Accounts” to simplify the description and maintain the focus on Social Security and Medicare.



spending than would have occurred in the absence of the loans. In this latter extreme, trust fund loans result in additional largess (i.e., higher spending and/or lower taxes) in General Fund programs at the time the loans are extended, but ultimately that additional largess is financed with additional austerity (i.e., lower spending and/or higher taxes) in General Fund programs at later dates. The actual impact of trust fund loans to the General Fund and their repayment on General Fund programs is at one of these two extremes or somewhere in between.

Actual dollar amounts roughly corresponding to the flows presented in Figure 1 are shown in Table 1 for fiscal year 2012. In Table 1, revenues from the public (left side of Figure 1) and expenditures to the public (right side of Figure 1) are shown separately from transfers between Government accounts (middle of Figure 1). Note that the transfers (\$323.5 billion) and interest credits (\$126.6 billion) received by the trust funds appear as negative entries under "Other Government" and are thus offsetting when summed for the total budget column. These two intragovernmental transfers are the key to the differences between the trust fund and budget perspectives.

From the Governmentwide perspective, only revenues received from the public (and States in the case of Medicare, Part D) and expenditures made to the public are important for the final balance. Trust fund revenue from the public consists of payroll taxes, benefit taxes, and premiums. For HI, the difference between total expenditures made to the public (\$258.2 billion) and revenues (\$229.7 billion) was (\$28.5 billion) in 2012, indicating that HI had a relatively small negative effect on the overall budget outcome *in that year*. For the SMI account, revenues from the public (premiums) were relatively small, representing about a quarter of total expenditures made to the public in 2012. The difference (\$214.6 billion) resulted in a net draw on the overall budget balance in that year. For OASDI, the difference between total expenditures made to the public (\$773.2 billion) and revenues from the public (\$613.3 billion) was (\$159.9) billion in 2012, indicating that OASDI had a negative effect on the overall budget outcome *in that year*. OASDI payroll tax revenues were reduced by \$112.2 billion in fiscal year 2012 by a temporary 2 percentage point reduction in the payroll tax rate paid by employees and self-employed individuals called for by Public Laws 111-312, 112-78 and 112-96.

The trust fund perspective is captured in the bottom section of each of the three trust fund columns. For HI, total expenditures exceeded total revenues by \$16.5 billion in 2012, as shown at the bottom of the first column. This cash deficit was made up by calling in past loans made to the General Fund (i.e., by redeeming Trust Fund assets). For SMI, total expenditures exceeded total revenues by \$1.1 billion. The total revenue for SMI is \$290.9 billion (\$77.4 + \$213.5), which includes \$210.6 billion transferred from other Government accounts (the General Fund). Transfers to the SMI Program from other Government accounts (the General Fund), amounting to about 72 percent of program costs, are obligated under current law and, therefore, appropriately viewed as revenue from the trust fund perspective. For OASDI, total revenues of \$837.9 billion exceeded total expenditures of \$773.2 billion by \$64.7 billion. Total revenues for OASDI included \$224.6 billion of transfers from the General Fund, principally interest credits and \$112.4 billion in credits called for by Public Laws 111-312, 112-78 and 112-96 to make up for the reduction in payroll tax revenues attributable to the temporary payroll tax rate reductions.

**Table 1**  
**Revenues and Expenditures for Medicare and Social Security**  
**Trust Funds and the Total Federal Budget**  
**for the Fiscal Year ended September 30, 2012**

(In billions of dollars)	Trust Funds					Total <sup>1</sup>
	HI	SMI	OASDI	Total	All Other	
<b>Revenues from the public and States:</b>						
Payroll and benefit taxes, State grants...	223.4		613.3	836.7		836.7
Premiums .....	6.3	66.3		72.6		72.6
Other taxes and fees .....		11.1		11.1	1,528.7	1,539.8
Total.....	229.7	77.4	613.3	920.4	1,528.7	2,449.1
Total expenditures to the public <sup>2</sup> .....	258.2	292.0	773.2	1,323.4	2,215.2	3,538.5
<b>Net results—budget perspective<sup>3</sup> .....</b>	<b>(28.5)</b>	<b>(214.6)</b>	<b>(159.9)</b>	<b>(403.0)</b>	<b>(686.4)</b>	<b>(1,089.4)</b>
<b>Revenues from other Government accounts:</b>						
Transfers .....	0.7	210.6	112.2	323.5	(323.5)	
Interest credits .....	11.3	2.9	112.4	126.6	(126.6)	
Total.....	12.0	213.5	224.6	450.1	(450.1)	
<b>Net results—trust fund perspective</b> <b>(change in trust fund balance)<sup>3</sup> .....</b>	<b>(16.5)</b>	<b>(1.1)</b>	<b>64.7</b>	<b>47.1</b>	<b>N/A</b>	<b>N/A</b>

<sup>1</sup> This column is the sum of the preceding two columns and shows data for the total Federal budget. The figure \$1,089.4 billion was the total Federal deficit in fiscal year 2012.

<sup>2</sup> The OASDI figure includes \$4.7 billion transferred to the Railroad Retirement Board for benefit payments and is, therefore, an expenditure to the public.

<sup>3</sup> Net results are computed as revenues less expenditures.

Notes: Amounts may not add due to rounding.

"N/A" indicates not applicable.

## Cashflow Projections

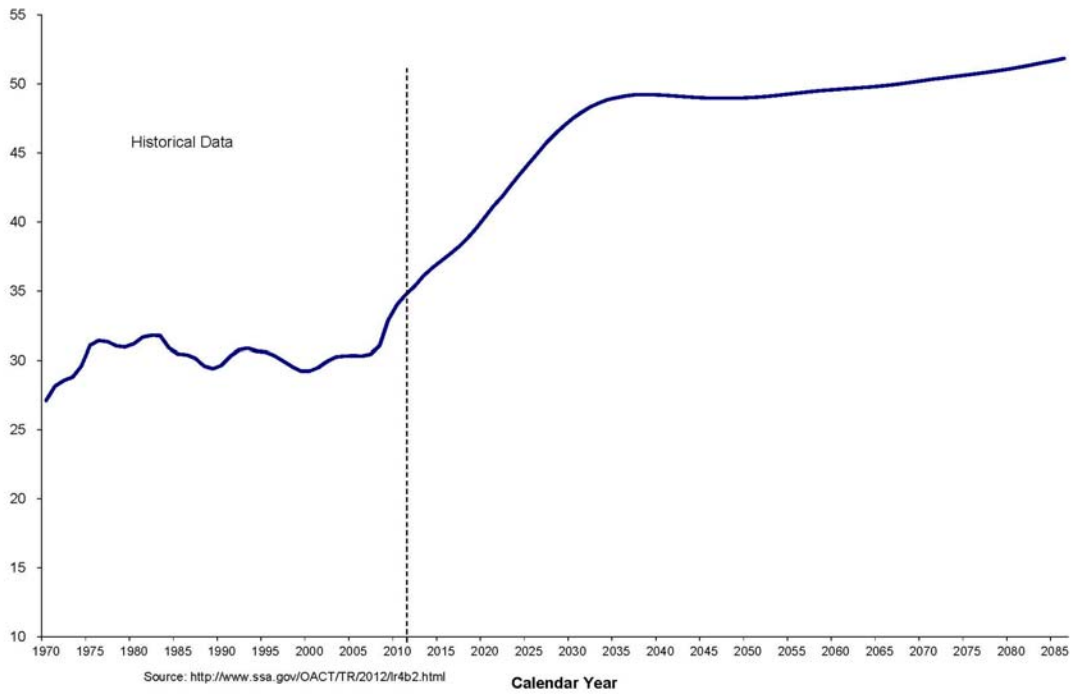
### Background

*Economic and Demographic Assumptions.* The Boards of Trustees<sup>4</sup> of the OASDI and Medicare Trust Funds provide in their annual reports to Congress short-range (10-year) and long-range (75-year) actuarial estimates of each trust fund. Because of the inherent uncertainty in estimates for 75 years into the future, the Boards use three alternative sets of economic and demographic assumptions to show a range of possibilities. The economic and demographic assumptions used for the most recent set of intermediate projections for Social Security and Medicare are shown in the "Social Security" and "Medicare" sections of Note 26—Social Insurance.

<sup>4</sup> There are six trustees: the Secretaries of the Treasury (managing trustee), Health and Human Services, and Labor; the Commissioner of the Social Security Administration; and two public trustees who are appointed by the President and confirmed by the Senate for a 4-year term. By law, the public trustees cannot both be members of the same different political party.

*Beneficiary-to-Worker Ratio.* The expenditure projections for both the OASDI and Medicare Programs reflect the aging of the large baby-boom generation, born in the years 1946 to 1964, and its ultimate passing. Chart 1 shows that the number of OASDI beneficiaries per 100 covered workers is projected to grow rapidly from 35 in 2012 to 49 in 2035 as the baby boom generation enter their retirement years and receives benefits. After 2035 the baby boom’s influence will have dissipated, and it is projected that the beneficiary-worker ratio will continue to rise but at a slower pace due to increasing longevity, reaching 52 beneficiaries per 100 workers in 2086. (In rough terms, the beneficiary-to-worker ratio at any point in time reflects the birth rates experienced by the generations who are retired; the birth rates of the baby boom generations’ parents were much higher than those of the baby boomer generations and the generations to follow them.) A similar demographic pattern confronts the Medicare Program.

**Chart 1—OASDI Beneficiaries per 100 Covered Workers  
1970-2086**

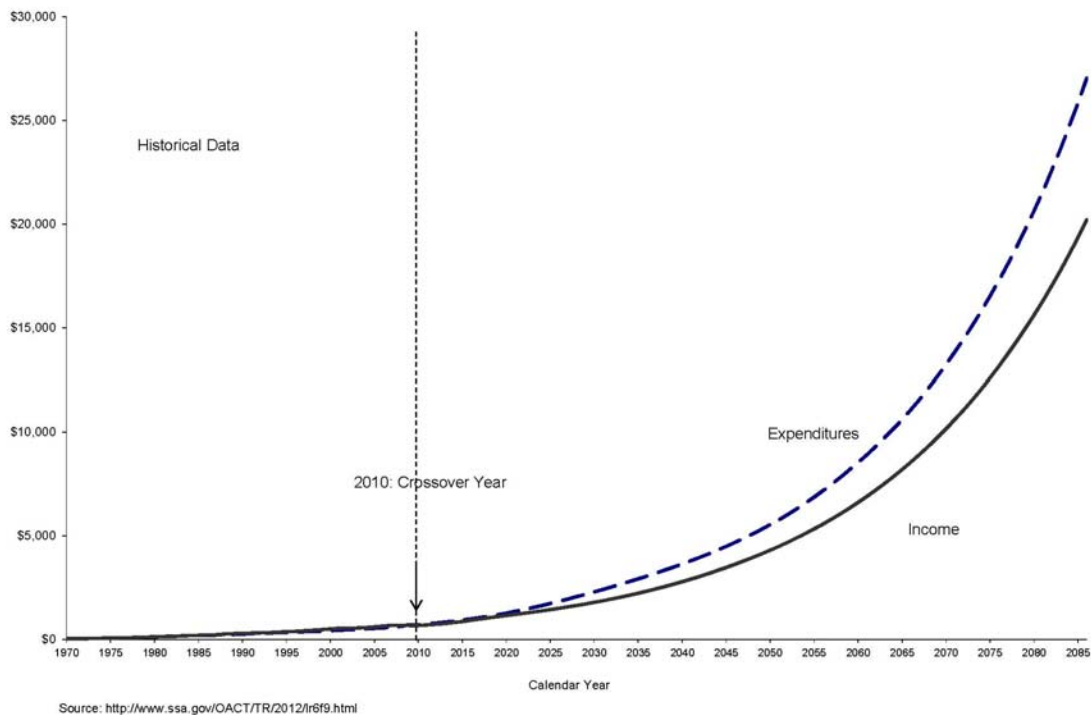


## Social Security Projections

*Income and Expenditures.* Chart 2 shows historical values and actuarial estimates of combined OASDI annual noninterest income and expenditures for 1970-2086. The estimates are for the open-group population of all workers and beneficiaries projected to be alive in each year. The expenditure projections in Chart 2 and all subsequent charts assume all scheduled benefits are paid regardless of whether the income and assets are available to finance them.

**Chart 2—OASDI Income (Excluding Interest) and Expenditures  
1970-2086**

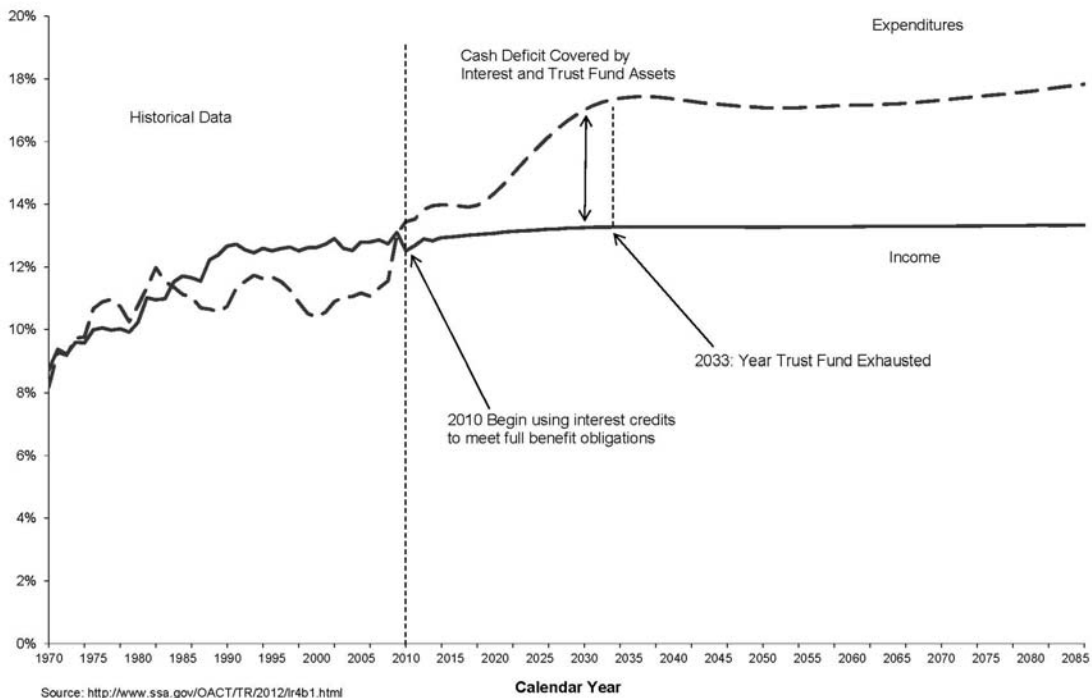
(In billions of dollars)



Social Security's surplus of noninterest income over expenditures was positive every year between 1984 and 2009, negative in 2010 through 2012, and is projected to grow ever more negative over the next 75 years. This pattern reflects the aging of the population documented in Chart 1, as well as growth of the economy and growth in the price level. As described above, surpluses that occurred prior to 2010 were "loaned" to the General Fund and accumulated, with interest, increasing reserve spending authority for the trust fund. The reserve spending authority represents an obligation for the General Fund. Social Security began using interest credits to meet full benefit obligations in 2010, and is projected to begin drawing down trust fund balances starting in 2021 and to exhaust those balances in 2033. After trust fund exhaustion, noninterest income will continue to flow into the fund and will be sufficient to finance 75 percent of scheduled benefits in 2033 and 73 percent of scheduled benefits in 2086.

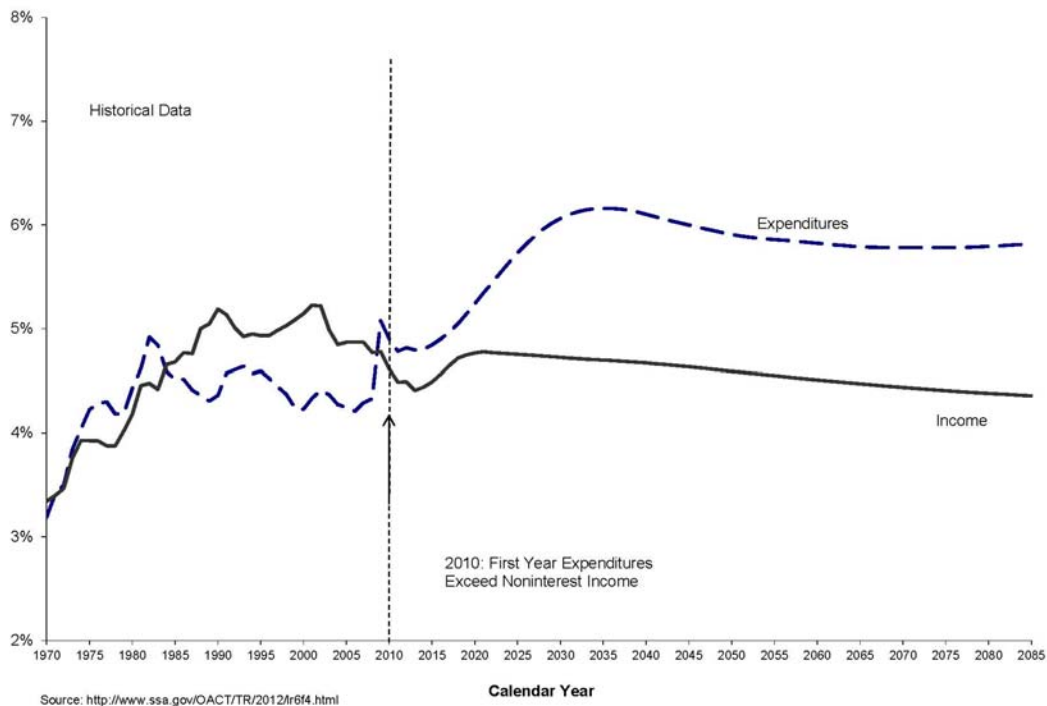
*Income and Expenditures as a Percent of Taxable Payroll.* Chart 3 shows annual noninterest income and expenditures expressed as percentages of taxable payroll, commonly referred to as the income rate and cost rate, respectively. Dividing noninterest income and expenditures by taxable payroll serves to isolate the effect of demographics on Social Security finances, and usefully gauges Social Security’s financial imbalances against the size of the Social Security tax base. The time path of the cost rate in Chart 3 closely parallels that of the beneficiary-to-worker ratio in Chart 1.

**Chart 3—OASDI Income (Excluding Interest) and Expenditures as a Percent of Taxable Payroll 1970-2086**



*Income and Expenditures as a Percent of GDP.* Chart 4 shows estimated annual noninterest income and expenditures, expressed as percentages of GDP, the total value of goods and services produced in the United States. This alternative perspective shows the size of the OASDI Program in relation to the capacity of the national economy to sustain it. The gap between expenditures and income generally widens with expenditures generally growing as a share of GDP and income declining slightly relative to GDP. Social Security's expenditures are projected to grow from 5.01 percent of GDP in 2012 to 6.10 percent in 2086. In 2086, expenditures are projected to exceed income by 1.54 percent of GDP.

**Chart 4—OASDI Income (Excluding Interest) and Expenditures  
as a Percent of GDP  
1970-2086**



*Sensitivity Analysis.* Actual future income from OASDI payroll taxes and other sources and actual future expenditures for scheduled benefits and administrative expenses will depend upon a large number of factors: the size and composition of the population that is receiving benefits, the level of monthly benefit amounts, the size and characteristics of the work force covered under OASDI, and the level of workers' earnings. These factors will depend, in turn, upon future marriage and divorce rates, birth rates, death rates, migration rates, labor force participation and unemployment rates, disability incidence and termination rates, retirement age patterns, productivity gains, wage increases, cost-of-living increases, and many other economic and demographic factors.

This section presents estimates that illustrate the sensitivity of long-range expenditures and income for the OASDI Program to changes in *selected individual assumptions*. In this analysis, the intermediate assumption is used as the reference point, and one assumption at a time is varied. The variation used for each individual assumption reflects the levels used for that assumption in the low-cost (Alternative I) and high-cost (Alternative III) projections. For example, when analyzing sensitivity with respect to variation in real wages, income and expenditure projections using the intermediate assumptions are compared to the outcome when projections are done by changing only the real wage assumption to either low-cost or high-cost alternatives.

The low-cost alternative is characterized by assumptions that generally improve the financial status of the program (relative to the intermediate assumption) such as slower improvement in mortality (beneficiaries die younger). In contrast, assumptions under the high-cost alternative generally worsen the financial outlook. One exception occurs with the CPI assumption (see below).

Table 2 shows the effects of changing individual assumptions on the present value of estimated OASDI expenditures in excess of income (the *shortfall* of income relative to expenditures in present value terms). The assumptions are shown in parentheses. For example, the intermediate assumption for the annual rate of *reduction in age-sex-adjusted death rates* is 0.77 percent. For the low-cost alternative, a slower reduction rate (0.39 percent) is assumed as it means that beneficiaries die at a younger age relative to the intermediate assumption, resulting in lower expenditures. Under the low-cost assumption, the shortfall drops from \$11,278 billion to \$9,595 billion, a 15 percent smaller shortfall. The high-cost death rate assumption (1.18 percent) results in an increase in the shortfall, from \$11,278 billion to \$13,069 billion, a 16 percent increase in the shortfall. Clearly, alternative death rate assumptions have a substantial impact on estimated future cashflows in the OASDI Program.

A higher fertility rate means more workers relative to beneficiaries over the projection period, thereby lowering the shortfall relative to the intermediate assumption. An increase in the rate from 2.0 to 2.3 percent results in a 9 percent smaller shortfall (i.e., expenditures less income), from \$11,278 billion to \$10,217 billion.

Higher real wage growth results in faster income growth relative to expenditure growth. Table 2 shows that a real wage differential that is 0.59 percentage point greater than the intermediate assumption of 1.12 causes the shortfall to drop from \$11,278 billion to \$9,177 billion, a 19 percent decline.

The CPI change assumption operates in a somewhat counterintuitive manner, as seen in Table 2. A lower rate of change results in a higher shortfall. This arises as a consequence of holding the real wage assumption constant while varying the CPI so that wages (the income base) are affected sooner than benefits. If the rate is assumed to be 1.8 percent rather than 2.8 percent, the shortfall increases about 5 percent, from \$11,278 billion to \$11,853 billion.

The effect of net immigration is similar to fertility in that, over the 75-year projection period, higher immigration results in proportionately more workers (taxpayers) than beneficiaries. The low-cost assumption for net immigration results in a 4 percent drop in the shortfall, from \$11,278 billion to \$10,836 billion, relative to the intermediate case; and the high-cost assumption results in a 5 percent higher shortfall.

Finally, Table 2 shows the sensitivity of the shortfall to variations in the real interest rate or, in present value terminology, the sensitivity to alternative discount rates assuming a higher discount rate results in a lower present value. The shortfall is 14 percent lower, decreasing from \$11,278 billion to \$9,653 billion, when the real interest rate is 3.4 percent rather than 2.9 percent. The shortfall is 18 percent higher, increasing to \$13,303 billion, when the real interest rate is 2.4 percent rather than 2.9 percent.

**Table 2**  
**Present Values of Estimated OASDI Expenditures in Excess of Income**  
**Under Various Assumptions, 2012-2086**

(Dollar values in billions; values of assumptions shown in parentheses)

Assumption	Financing Shortfall Range		
	Low	Intermediate	High
Average annual reduction in death rates.....	9,595 (0.39)	11,278 (0.77)	13,069 (1.18)
Total fertility rate .....	10,217 (2.3)	11,278 (2.0)	12,313 (1.7)
Real wage differential .....	9,177 (1.71)	11,278 (1.12)	12,745 (0.5)
CPI change .....	10,696 (3.8)	11,278 (2.8)	11,853 (1.8)
Net immigration.....	10,836 (1,375,000) <sup>1</sup>	11,278 (1,080,000) <sup>1</sup>	11,789 (790,000) <sup>1</sup>
Real interest rate.....	9,653 (3.4)	11,278 (2.9)	13,303 (2.4)

<sup>1</sup> Amounts represent the average annual net immigration over the 75-year projection period.

Source: 2012 OASDI Trustees Report and SSA.

## Medicare Projections

*Medicare Legislation.* The Affordable Care Act as amended by the Health Care and Education Reconciliation Act of 2010 (the “Affordable Care Act” or ACA) significantly improves projected Medicare finances. The most important cost saving provision in the ACA is a revision in payment rate updates for Parts A and B services other than for physicians’ services. Relative to payment rates made under prior law that were generally based on the rate at which prices for inputs used to provide Medicare services increase, the ACA reduces those payment rate updates by the rate at which productive efficiency in the overall economy increases, which is projected to average 1.1 percent per year. The ACA also achieves substantial cost savings by benchmarking payment rates for private health plans providing Parts A and B services (Part C or Medicare Advantage) to more closely match per beneficiary costs. Partly offsetting these changes was an increase in prescription drug coverage. In addition, the ACA increases Part A revenues by: (a) taxing high-cost employer-provided health care plans and thereby giving employers incentives to increase the share of compensation paid as taxable earnings, and (b) imposing a new 0.9 percent surtax on earnings in excess of \$200,000 (individual tax return filers) or \$250,000 (joint tax return filers) starting in 2013.

The ACA substantially reduces the Medicare cost projections. Growth in Medicare cost per beneficiary in excess of growth in per capita GDP is referred to as “excess cost growth.” In the 2009 *Financial Report*, the last Report released prior to the passage of the ACA, excess cost growth was assumed to be about 1 percentage point—that is, Medicare expenditures per beneficiary were assumed to grow, on average, about one percentage point faster than per capita GDP over the long range. That assumption for excess cost growth in Medicare was optimistic in the sense that it is smaller than in recent history; excess cost growth averaged 1.6 percentage points between 1990 and 2007.<sup>5</sup> In this year’s *Financial Report*, as in the 2010 and 2011 Reports, long-term excess cost growth is essentially

<sup>5</sup> Congressional Budget Office, the Long-Term Budget Outlook, June 2011.



zero. As a result, the long term projected Medicare spending share of GDP in this Report is driven primarily by the same demographic trends that drive the OASDI spending share of GDP.

The 2012 Medicare Trustees' Report warns that the "actual future costs for Medicare are likely to exceed those shown by the current-law projections" that underlie both the Trustees' Report and this *Financial Report*. This warning is due in part to concerns the new productivity-based downward adjustments to Medicare payment rate updates may not be sustainable, leading to substantial uncertainty about the adequacy of future Medicare payments rates. This concern is reinforced by the fact that statutory adjustments to payment rates for Medicare physicians' services mandated by a 1996 Medicare reform have been consistently overridden by new law.

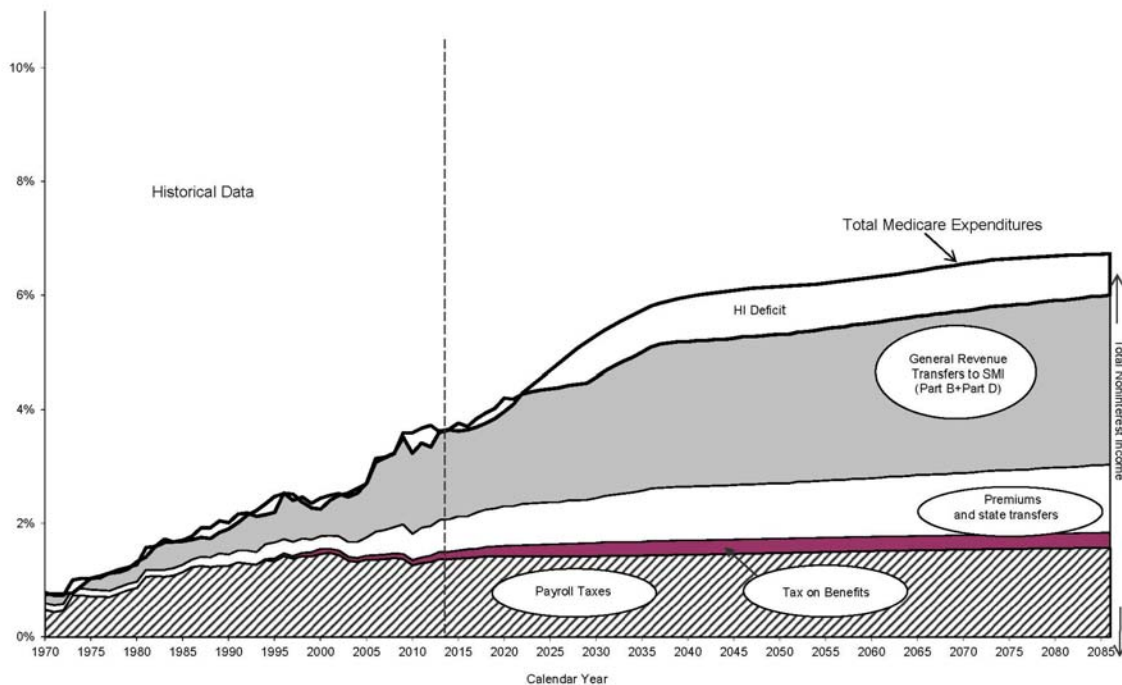
*Changes in Projection Methods.* For the 2012 Medicare Trustees Report, based on the recommendation of the 2010-2011 Medicare Technical Review Panel, the Board of Trustees adopted a long-range pre-ACA baseline cost growth assumption of "GDP plus 1.4 percent" and a "factors contributing to growth" model, which creates specific, year-by-year declining growth rates during the last 50 years of the projection period.

The ACA permanently reduces the annual increases in Medicare rates for most categories of health service providers by the increase in economy-wide productivity. Thus, the long-range cost growth rate for affected providers is set equal to the pre-ACA baseline growth assumptions, minus the increase in economy-wide multifactor productivity (1.1 percent). For the 2012 report, the Medicare Technical Panel concluded that the slower payment updates would have a small, net downward effect on growth in the volume and intensity of services. Based on this conclusion, the growth rates are further adjusted by (0.1 percent) annually.

On net, changes for 2012 resulted in a decrease in the future net cashflow for total Medicare for Part A, these changes resulted in an increase to the present value of expenditures and a very slight decrease on the present value of revenue, with an overall decrease on the future net cashflow. For Part B, these changes increased the present value of expenditures.

*Total Medicare.* Chart 5 shows expenditures and current-law noninterest revenue sources for HI and SMI combined as a percentage of GDP. The total expenditure line shows Medicare costs rising to 6.73 percent of GDP by 2086. Revenues from taxes and premiums (including State transfers under Part D) are expected to increase from 1.93 percent of GDP in 2012 to 3.02 percent of GDP in 2086. Payroll tax income increases gradually as a percent of GDP because the new tax on earnings in excess of \$250,000 for joint tax return filers and \$200,000 for individual tax return filers applies to an increasing share of earnings because the \$250,000 and \$200,000 thresholds are not indexed for price changes. Premiums combined for Parts B and D of SMI are approximately fixed as a share of Parts B and D costs, so they also increase as a percent of GDP. General revenue contributions for SMI, as determined by current law, are projected to rise as a percent of GDP from 1.39 percent to 2.97 percent over the same period. Thus, revenues from taxes and premiums (including State transfers) will fall substantially as a share of total noninterest Medicare income (from 58 percent in 2012 to 50 percent in 2086) while general revenues will rise (from 42 percent to 50 percent). The gap between total noninterest Medicare income (including general revenue contributions) and expenditures begins around 2012 and then steadily continues to widen, reaching 0.7 percent of GDP by 2086.

**Chart 5—Total Medicare (HI and SMI) Expenditures and Noninterest Income as a Percent of GDP 1970-2086**

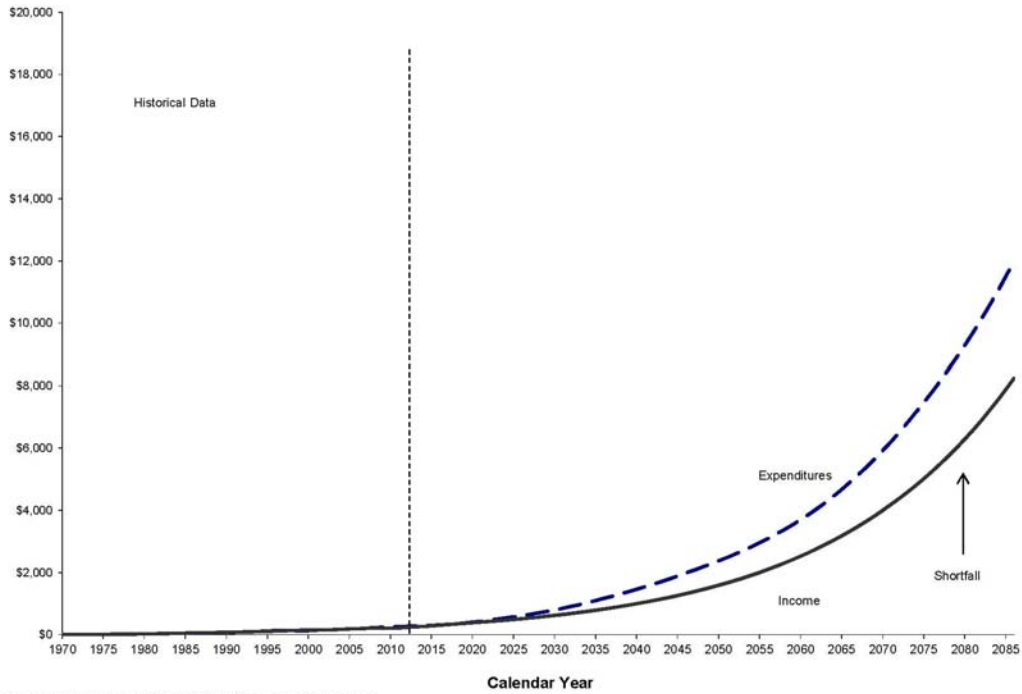


Source: [http://www.ssa.gov/OACT/TRSUM/images/LD\\_ChartC.html](http://www.ssa.gov/OACT/TRSUM/images/LD_ChartC.html)

*Medicare, Part A (Hospital Insurance)— Income and Expenditures.* Chart 6 shows historical and actuarial estimates of HI annual income (excluding interest) and expenditures for 1970-2086 in nominal dollars. The estimates are for the open-group population.

**Chart 6—Medicare Part A Income (Excluding Interest) and Expenditures  
1970-2086**

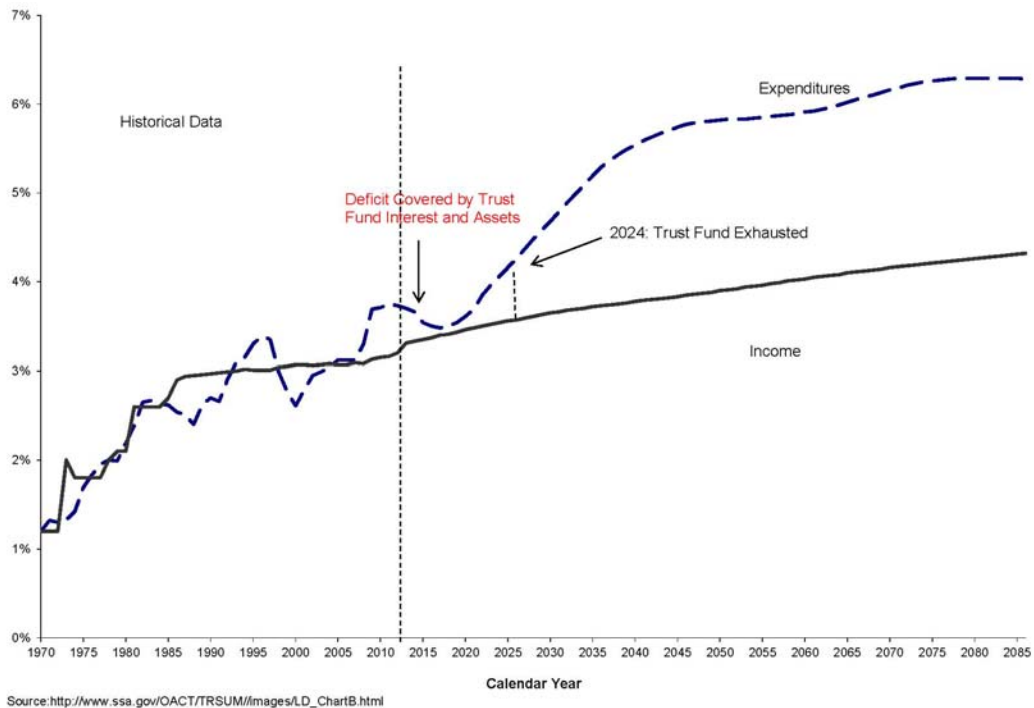
(In billions of dollars)



Source: [http://www.ssa.gov/OACT/TRSUM/images/LD\\_ChartB.html](http://www.ssa.gov/OACT/TRSUM/images/LD_ChartB.html)

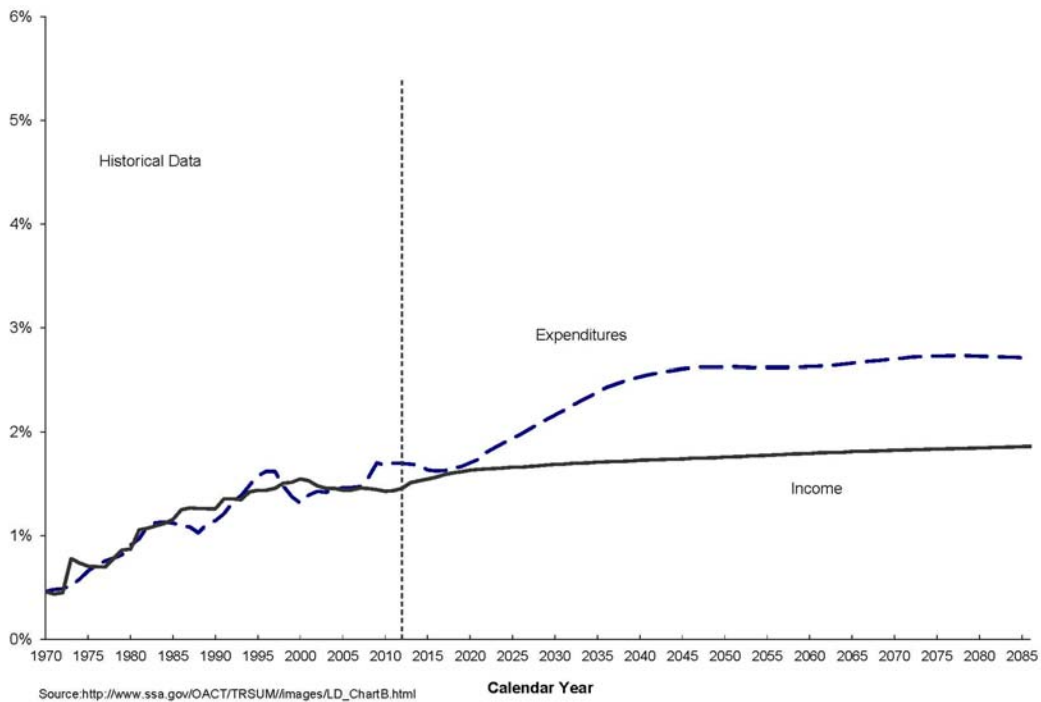
*Medicare, Part A Income and Expenditures as a Percent of Taxable Payroll.* Chart 7 illustrates income (excluding interest) and expenditures as a percentage of taxable payroll over the next 75 years. The chart shows that the expenditure rate exceeds the income rate in 2008, and cash deficits continue thereafter. Trust fund interest earnings and assets provide enough resources to pay full benefit payments until 2024 with general revenues used to finance interest and loan repayments to make up the difference between cash income and expenditures during that period. Pressures on the Federal budget will thus emerge well before 2024. Present tax rates would be sufficient to pay 87 percent of scheduled benefits after trust fund exhaustion in 2024 and 69 percent of scheduled benefits in 2086.

**Chart 7—Medicare Part A Income (Excluding Interest) and Expenditures as a Percent of Taxable Payroll 1970-2086**



*Medicare, Part A Income and Expenditures as a Percent of GDP.* Chart 8 shows estimated annual noninterest income and expenditures, expressed as percentages of GDP, and the total value of goods and services produced in the United States. This alternative perspective shows the size of the HI Program in relation to the capacity of the national economy to sustain it. Medicare Part A's expenditures are projected to grow from 1.7 percent of GDP in 2012, to 2.16 percent in 2030, and to 2.71 percent by 2086. The gap between expenditure and income shares of GDP widens and peaks at 0.87 percent in 2046 and then commences a slight decline, reaching 0.85 percent of GDP in 2086.

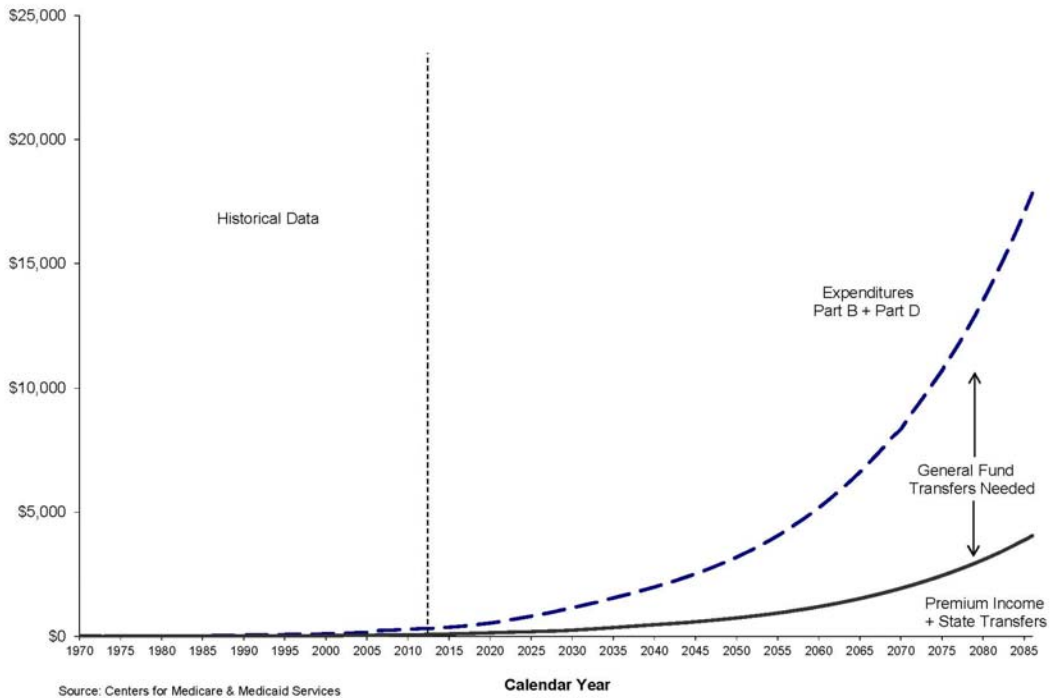
**Chart 8—Medicare Part A Income (Excluding Interest) and Expenditures as a Percent of GDP 1970-2086**



*Medicare, Parts B and D (Supplementary Medical Insurance).* Chart 9 shows historical and actuarial estimates of Medicare Part B and Part D premiums (and Part D State transfers) and expenditures for each of the next 75 years, in dollars. The gap between premiums and State transfer revenues and program expenditures, a gap that will need to be filled with transfers from general revenues, grows throughout the projection period.

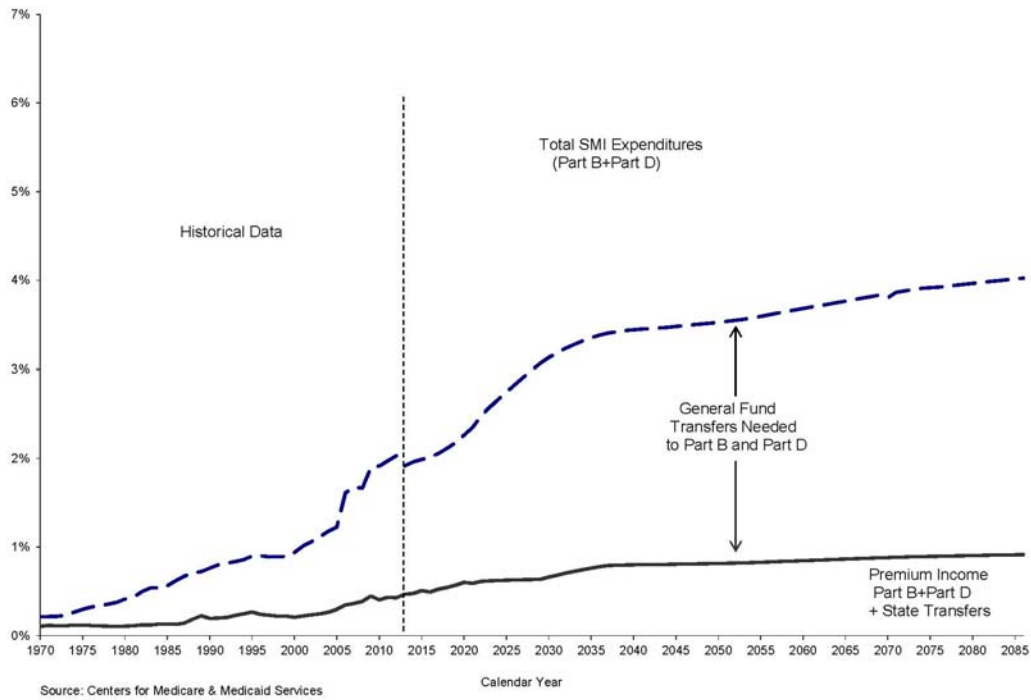
**Chart 9—Medicare Part B and Part D Premium and State Transfer Income and Expenditures  
1970-2086**

(In billions of dollars)



*Medicare Part B and Part D Premium and State Transfer Income and Expenditures as a Percent of GDP.* Chart 10 shows expenditures for the Supplementary Medical Insurance Program over the next 75 years expressed as a percentage of GDP, providing a perspective on the size of the SMI Program in relation to the capacity of the national economy to sustain it. SMI expenditures as a share of GDP are expected to grow rapidly from 2.03 percent in 2012 to 3.35 percent in 2035, and then grow more slowly reaching 4.02 in 2086. This growth pattern reflects growth in Medicare spending per beneficiary that is positive for the first half of the projection period before turning negative as a result of provisions in the ACA and population ageing that is rapid through 2035 as the baby boom generation move into their advanced years and then slows to a modest pace consistent with increasing longevity. Premium and State transfer income grows from about 0.50 in 2012 to 1.06 percent of GDP in 2086, so the portion financed by General Fund transfers to SMI is projected to be about 75 percent throughout the projections period.

**Chart 10—Medicare Part B and Part D Premium and State Transfer Income and Expenditures as a Percent of GDP 1970-2086**



*Medicare Sensitivity Analysis.* This section illustrates the sensitivity of long-range cost and income estimates for the Medicare Program to changes in *selected individual assumptions*. As with the OASDI analysis, the intermediate assumption is used as the reference point, and one assumption at a time is varied. The variation used for each individual assumption reflects the levels used for that assumption in the low-cost and high-cost projections (see description of sensitivity analysis for OASDI).

Table 3 shows the effects of changing various assumptions on the present value of estimated HI expenditures in excess of income (the *shortfall* of income relative to expenditures in present value terms). The assumptions are shown in parentheses. Clearly, net HI expenditures are extremely sensitive to alternative assumptions about the

growth in health care cost. For the low-cost alternative, the slower growth in health costs causes the shortfall to drop from \$5,581 billion to a surplus of \$533 billion, a 110 percent change. The high-cost assumption results in a near tripling of the shortfall, from \$5,581 billion to \$15,332 billion.

Variations in the next four assumptions in Table 3 result in relatively minor changes in net HI expenditures. The higher or lower fertility assumptions cause an approximate 7 percent change in the shortfall relative to the intermediate case. The higher or lower real wage growth rate results in about a 13 and 5 percent respectively, change in the shortfall relative to the intermediate case. Wages are a key cost factor in the provision of health care. Higher wages also result in greater payroll tax income. HI expenditures exceed HI income by a wide and increasing margin in the future (Charts 6 to 8). CPI and net immigration changes have very little effect on net HI expenditures. Higher immigration decreases the net shortfall modestly as higher payroll tax revenue offsets higher medical care expenditures.

Table 3 also shows that the present value of net HI expenditures is 18 percent lower if the real interest rate is 3.4 percent rather than 2.9 percent and 20 percent higher if the real interest rate is 2.4 percent rather than 2.9 percent.

**Table 3**  
**Present Values of Estimated Medicare Part A Expenditures in Excess of**  
**Income Under Various Assumptions, 2012-2086**

(Dollar values in billions; values of assumptions shown in parentheses)

Assumption <sup>1</sup>	Financing Shortfall Range		
	Low	Intermediate	High
Average annual growth in health costs <sup>2</sup> .....	(533) (3.3)	5,581 (4.3)	15,332 (5.3)
Total fertility rate <sup>3</sup> .....	5,199 (2.3)	5,581 (2.0)	5,947 (1.7)
Real wage differential .....	4,839 (1.7)	5,581 (1.1)	5,860 (0.5)
CPI change .....	5,316 (3.8)	5,581 (2.8)	5,812 (1.8)
Net immigration.....	5,509 (1,375,000) <sup>4</sup>	5,581 (1,080,000) <sup>4</sup>	5,663 (790,000) <sup>4</sup>
Real interest rate.....	4,558 (3.4)	5,581 (2.9)	6,713 (2.4)

<sup>1</sup> The sensitivity of the projected HI net cashflow to variations in future mortality rates also is of interest. At this time, however, relatively little is known about the relationship between improvements in life expectancy and the associated changes in health status and per beneficiary health expenditures. As a result, it is not possible at present to prepare meaningful estimates of the Part A, mortality sensitivity.

<sup>2</sup> Annual growth rate is the aggregate cost of providing covered health care services to beneficiaries. The low-cost and high-cost alternatives assume that costs increase 1 percent slower or faster, respectively, than the intermediate assumption, *relative to growth in taxable payroll*.

<sup>3</sup> The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime if she were to experience the birth rates by age observed in, or assumed for, the selected year and if she were to survive the entire childbearing period.

<sup>4</sup> Amount represents the average annual net immigration over the 75-year projection period.



Table 4 shows the effects of various assumptions about the growth in health care costs on the present value of estimated SMI (Medicare Parts B and D) expenditures in excess of income. As with HI, net SMI expenditures are very sensitive to changes in the health care cost growth assumption. For the low-cost alternative, the slower assumed growth in health costs reduces the Governmentwide resources needed for Part B from \$14,815 billion to \$10,735 billion and in Part D from \$6,778 billion to \$4,778 billion, about a 28 percent and 30 percent difference for Part B and Part D, respectively. The high-cost assumption increases Governmentwide resources needed to \$21,162 billion for Part B and to \$9,949 billion for Part D, about a 43 percent and a 47 percent difference for Part B and Part D, respectively.

**Table 4**  
**Present Values of Estimated Medicare Parts B and D Future Expenditures Less Premium Income and State Transfers Under Three Health Care Cost Growth Assumptions, 2012-2086**

(In billions of dollars)

Medicare Program <sup>1</sup>	Governmentwide Resources Needed		
	Low (3.3)	Intermediate (4.3)	High (5.3)
Part B .....	10,735	14,815	21,162
Part D .....	4,778	6,778	9,949

<sup>1</sup> Annual growth rate is the aggregate cost of providing covered health care services to beneficiaries. The low and high scenarios assume that costs increase one percent slower or faster, respectively, than the intermediate assumption.

Source: Centers for Medicare and Medicaid Services.

## Sustainability of Social Security and Medicare

### 75-Year Horizon

According to the 2012 Medicare Trustees Report, the HI Trust Fund is projected to remain solvent until 2024 and, according to the 2012 Social Security Trustees Report, the OASDI Trust Funds are projected to remain solvent until 2033. In each case, some general revenues must be used to satisfy the authorization of full benefit payments until the year of exhaustion. This occurs when the trust fund balances accumulated during prior years are needed to pay benefits, which leads to a transfer from general revenues to the trust funds. Moreover, under current law, General Fund transfers to the SMI Trust Fund will occur into the indefinite future and will continue to grow with the growth in health care expenditures.

The potential magnitude of future financial obligations under these three social insurance programs is, therefore, important from a unified budget perspective as well as for understanding generally the growing resource demands of the programs on the economy. A common way to present future cashflows is in terms of their *present value*. This approach recognizes that a dollar paid or collected next year is worth less than a dollar today because a dollar today could be saved and earn a year's worth of interest.

Table 5 shows the magnitudes of the primary expenditures and sources of financing for the three trust funds computed on an open-group basis for the next 75 years and expressed in present values. The data are consistent with the Statements of Social Insurance included in the principal financial statements. For HI, revenues from the public are projected to fall short of total expenditures by \$5,581 billion in present value terms which is the additional amount needed in order to pay scheduled benefits over the next 75 years.<sup>6</sup> From the trust fund perspective, the amount needed is \$5,337 billion in present value after subtracting the value of the existing trust fund balances (an asset to the trust fund account but an intragovernmental transfer to the overall budget). For SMI, revenues from the public for Parts B and D combined are estimated to be \$21,593 billion less than total expenditures for the two

<sup>6</sup> Interest income is not a factor in this table as dollar amounts are in present value terms.

accounts, an amount that, from a budget perspective, will be needed to keep the SMI program solvent for the next 75 years. From the trust fund perspective, however, the present values of total revenues and total expenditures for the SMI Program are roughly equal due to the annual adjustment of revenue from other Government accounts to meet program costs.<sup>7</sup> For OASDI, projected revenues from the public fall short of total expenditures by \$11,278 billion in present value dollars, and, from the trust fund perspective, by \$8,600 billion.

From the Governmentwide perspective, the present value of the total resources needed for the Social Security and Medicare Programs over and above current-law funding sources (payroll taxes, benefit taxes, and premium payments from the public) is \$38,454 billion. From the trust fund perspective, which counts the trust funds (\$3,003 billion in present value) and the general revenue transfers to the SMI Program (\$21,593 billion in present value) as dedicated funding sources, additional resources needed to fund the programs are \$13,858 billion in present value.

**Table 5**  
**Present Values of Costs Less Revenues of 75-Year Open-Group Obligations**  
**HI, SMI, and OASDI**

(In billions of dollars, as of January 1, 2012)

	HI	SMI		OASDI	Total
		Part B	Part D		
<b>Revenues from the public:</b>					
Taxes.....	15,598	-	-	45,198	60,796
Premiums, State transfers.....	-	5,344	2,349	-	7,693
Total.....	15,598	5,344	2,349	45,198	68,489
<b>Total costs to the public.....</b>	<b>21,179</b>	<b>20,159</b>	<b>9,128</b>	<b>56,477</b>	<b>106,943</b>
<b>Net results — budget perspective</b>					
.....	5,581	14,815	6,778	11,278	38,454
Revenues from other					
Government accounts.....	-	14,815	6,778	-	21,593
Trust fund balance as of 1/1/2012.....	244	80	1	2,678	3,003
<b>Net results — trust fund perspective</b>	<b>5,337</b>	<b>(80)</b>	<b>(1)</b>	<b>8,600</b>	<b>13,858</b>

\*Net results are computed as costs less revenues.

Note: Details may not add to totals due to rounding.

Source: 2012 OASDI and Medicare Trustees' Reports.

## Infinite Horizon

The 75-year horizon represented in Table 5 is consistent with the primary focus of the Social Security and Medicare Trustees' Reports. For the OASDI Program, for example, an additional \$11.3 trillion in present value will be needed above currently scheduled taxes to pay for scheduled benefits (\$8.6 trillion from the trust fund perspective). Yet, a 75-year projection can be a misleading indicator of all future financial flows. For example, when calculating unfunded obligations, a 75-year horizon includes revenue from some future workers but only a fraction of their future benefits. In order to provide a more complete estimate of the long-run unfunded obligations of the programs, estimates can be extended to the infinite horizon. The open-group infinite horizon net obligation is the present value of all expected future program outlays less the present value of all expected future program tax and premium revenues. Such a measure is provided in Table 6 for the three trust funds represented in Table 5.

<sup>7</sup> The SMI Trust Fund has \$81 billion of existing assets.

From the budget or Governmentwide perspective, the values in line 1 plus the values in line 4 of Table 6 represent the value of resources needed to finance each of the programs into the infinite future. The sums are shown in the last line of the table (also equivalent to adding the values in the second and fifth lines). The total resources needed for all the programs sums to \$66.3 trillion in present value terms. This need can be satisfied only through increased borrowing, higher taxes, reduced program spending, or some combination.

The second line shows the value of the trust fund at the beginning of 2012. For the HI and OASDI Programs this represents, from the trust fund perspective, the extent to which the programs are funded. From that perspective, when the trust fund is subtracted, an additional \$20.5 trillion is needed to sustain the OASDI program into the infinite future, while an additional \$4.9 trillion is needed to sustain the HI program. However, looking just at present values ignores timing differences in the underlying projected cashflows; the HI Trust Fund is projected to remain solvent only until 2024. As described above, from the trust fund perspective, the SMI Program is fully funded, from a Governmentwide basis, the substantial gap that exists between premiums and State transfer revenue and program expenditures in the SMI Program (\$23.6 trillion and \$14.3 trillion) represents future general revenue obligations of the Federal budget.

In comparison to the analogous 75-year number in Table 5, extending the calculations beyond 2086, captures the full lifetime benefits, and taxes and premiums of all current and future participants. The shorter horizon understates the total financial needs by capturing relatively more of the revenues from current and future workers and not capturing all of the benefits that are scheduled to be paid to them.

**Table 6**  
**Present Values of Costs Less Tax, Premium and State Transfer Revenue**  
**through the Infinite Horizon, HI, SMI, OASDI**

(In trillions of dollars as of January 1, 2012)

	HI	SMI		OASDI	Total
		Part B	Part D		
Present value of future costs less future taxes, premiums, and State transfers for current participants .....	10.1	12.4	4.9	24.3	51.7
Less current trust fund balance .....	0.2	0.1	-	2.7	3.0
Equals net obligations for past and current participants .....	9.9	12.3	4.9	21.6	48.7
Plus net obligations for future participants .....	(5.0)	11.3	9.4	(1.1)	14.6
Equals net obligations through the infinite future for all participants .....	<u>4.9</u>	<u>23.6</u>	<u>14.3</u>	<u>20.5</u>	<u>63.3</u>
Present values of future costs less the present values of future income over the infinite horizon .....	<u>5.1</u>	<u>23.7</u>	<u>14.3</u>	<u>23.2</u>	<u>66.3</u>

Details may not add to totals due to rounding.

Source: 2012 OASDI and Medicare Trustees' Reports.

## Railroad Retirement, Black Lung, and Unemployment Insurance

### Railroad Retirement

The Railroad Retirement Board (RRB) was created in the 1930s to establish a retirement benefit program for the Nation's railroad workers. As the Social Security Program legislated in 1935 would not give railroad workers credit for service performed prior to 1937, legislation was enacted in 1934, 1935, and 1937 (collectively the Railroad Retirement Acts of the 1930s) to establish a railroad retirement program separate from the Social Security Program.

Railroad retirement pays full retirement annuities at age 60 to railroad workers with 30 years of service. The program pays disability annuities based on total or occupational disability. It also pays annuities to spouses, divorced spouses, widow(er)s, remarried widow(er)s, surviving divorced spouses, children, and parents of deceased railroad workers. Medicare covers qualified railroad retirement beneficiaries in the same way as it does Social Security beneficiaries.

Payroll taxes paid by railroad employers and their employees provide a primary source of income for the Railroad Retirement and Survivors' Benefit Program. By law, railroad retirement taxes are coordinated with Social Security taxes. Employees and employers pay tier I taxes at the same rate as Social Security taxes. Tier II taxes finance railroad retirement benefit payments that are higher than Social Security levels.

Other sources of program income include: the RRB-SSA-CMS Financial Interchanges with the Social Security and Medicare trust funds, earnings on investments, Federal income taxes on railroad retirement benefits, and appropriations (provided after 1974 as part of a phase out of certain vested dual benefits). See Note 26—Social Insurance, for additional information on railroad retirement program financing.

The RRSIA liberalized benefits for 30-year service employees and their spouses, eliminated a cap on monthly benefits for retirement and disability benefits, lowered minimum service requirements from 10 to 5 years, and provided for increased benefits for widow(er)s. Per the RRSIA, amounts in the Railroad Retirement Account and the SSEB Account that are not needed to pay current benefits and administrative expenses may be transferred to the NRRIT or used to offset transfers from the NRRIT to the Railroad Retirement Account. The NRRIT's sole purpose is to manage and invest railroad retirement assets. NRRIT's Board of Trustees is empowered to invest trust assets in nongovernmental assets, such as equities and debt, as well as in Government securities. Prior to RRSIA, all investments were limited to Government securities.

Since its inception, NRRIT has received \$21.3 billion from RRB (including \$19.2 billion in fiscal year 2003, pursuant to RRSIA) and returned \$13.6 billion. During fiscal year 2012, the NRRIT made net transfers of \$2.0 billion to the RRB to pay retirement benefits. Administrative expenses of the trust are paid out of trust assets. The balance as of September 30, 2012, and 2011, of non-Federal securities and investments of the NRRIT are disclosed in Note 9—Debt and Equity Securities.

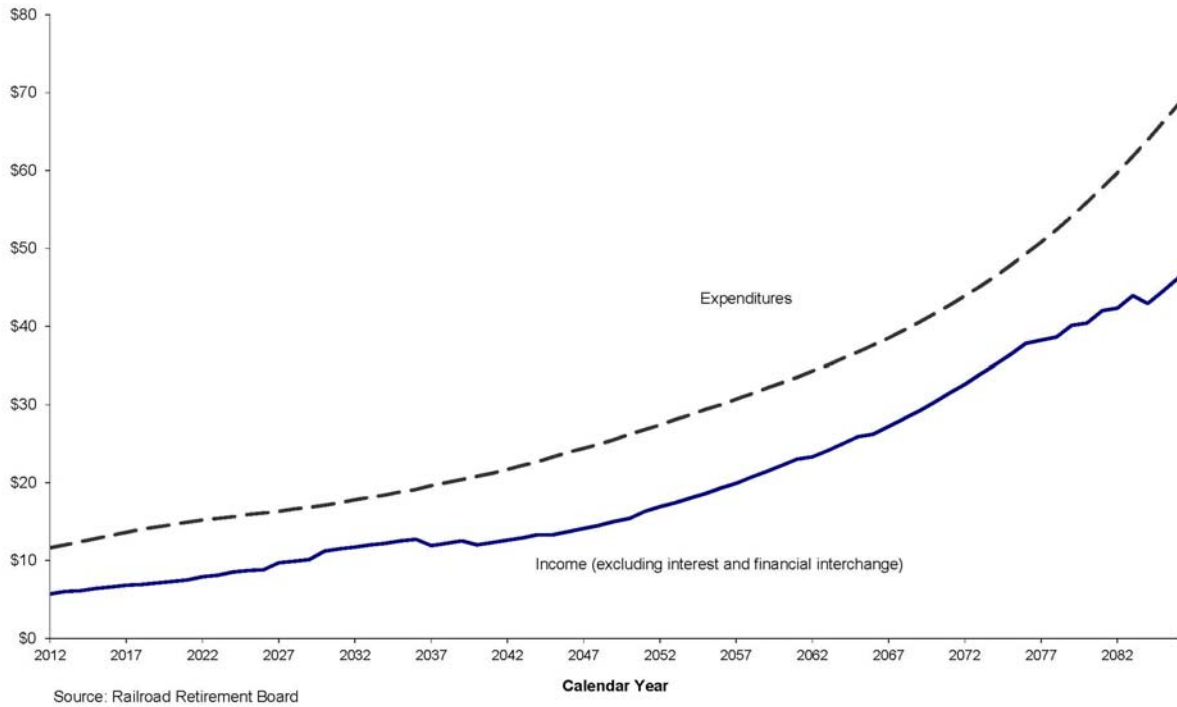
### Cashflow Projections

*Economic and Demographic Assumptions.* The economic and demographic assumptions used for the most recent set of projections are shown in the "Railroad Retirement" section of Note 26—Social Insurance.

*Income and Expenditures.* Chart 11 shows, in dollars, estimated railroad retirement income (excluding interest and financial interchange income) and expenditures for the period 2012-2086 based on the intermediate set of assumptions used in the RRB's actuarial evaluation of the program. The estimates are for the open-group population, which includes all persons projected to participate in the Railroad Retirement Program as railroad workers or beneficiaries during the period. Thus, the estimates include payments from, and on behalf of, those who are projected to be employed by the railroads during the period as well as those already employed at the beginning of the period. They also include expenditures made to, and on behalf of, such workers during that period.

**Chart 11—Estimated Railroad Retirement Income  
(Excluding Interest and Financial Interchange Income) and Expenditures  
2012-2086**

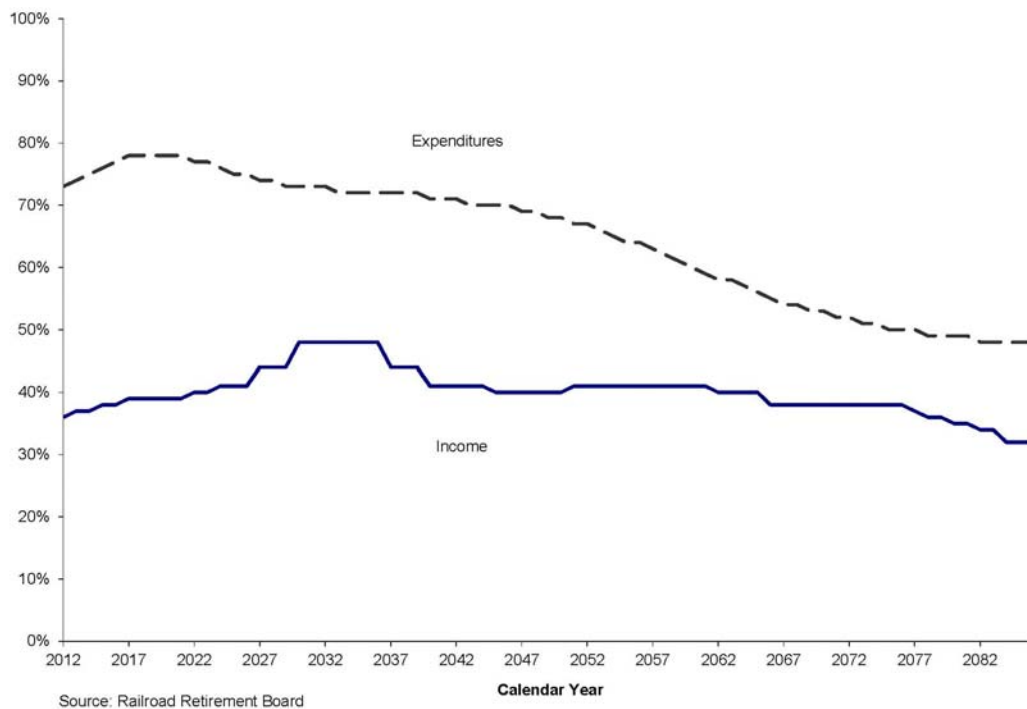
(In billions of dollars)



As Chart 11 shows, expenditures are expected to exceed tax income for the entire projection period. The imbalances continue to widen until about 2021, decrease slightly for the next 15 years, and then begin to grow steadily after 2036.

*Income and Expenditures as a Percent of Taxable Payroll.* Chart 12 shows estimated expenditures and income as a percent of tier II taxable payroll. The imbalances grow until 2021 but then begin to decrease somewhat steadily as expenditures fall. Tax rates begin to decline after 2036, stabilizing in 2066 through 2076, and declining thereafter. Compared to last year, projected tax rates are lower, on average. The tier II tax rate is determined from a tax rate table based on the average account benefit ratio.

**Chart 12—Estimated Railroad Retirement Income  
(Excluding Interest and Financial Interchange Income) and Expenditures  
as a Percent of Tier II Taxable Payroll  
2012-2086**



*Sensitivity Analysis.* Actual future income from railroad payroll taxes and other sources and actual future expenditures for scheduled benefits and administrative expenses will depend upon a large number of factors as mentioned above. Two crucial assumptions are employment growth and the interest rate. Table 7 shows the sensitivity of the shortfall in the Railroad Retirement Program to variations in these two assumptions. The low-cost employment scenario has a 6.1 percent smaller shortfall of income to expenditures, and the high-cost scenario has a 7.3 percent higher shortfall. A higher discount rate reduces future values relative to a lower rate. As seen in the table, the shortfall is 26.5 percent lower if the interest rate is 10 percent rather than 7.0 percent and 64.5 percent higher when the interest rate is 4.0 percent rather than 7.0 percent.

**Table 7**  
**Present Values of Railroad Retirement Expenditures in Excess of Income**  
**under Various Employment and Interest Rate Assumptions, 2012-2086**

(Dollar values in billions; values of assumptions shown in parentheses)

<b>Assumption</b>	<b>Low</b>	<b>Middle</b>	<b>High</b>
Employment <sup>1</sup> .....	100.4 (-0.5%)	107.0 (-2.0%)	114.8 (-3.5%)
Interest rate.....	78.6 (10.0%)	107.0 (7.0%)	176.0 (4.0%)

<sup>1</sup> The low and middle employment scenarios have passenger service employment remaining at 45,000 workers per year and the remaining employment base declining at 0.5 percent and 2.0 percent, respectively, for the next 25 years. The high-cost scenario has passenger service employment declining by 500 per workers per year until a level of 35,000 is reached with the remaining employment base declining by 3.5 percent per year for 25 years, at a reducing rate over the next 25 years, and remaining level thereafter.

Source: Railroad Retirement Board

### Sustainability of Railroad Retirement

Table 8 shows the magnitudes of the primary expenditures and sources of financing for the Railroad Retirement Program computed on an open-group basis for the next 75 years and expressed in present values as of January 1, 2012. The data are consistent with the Statements of Social Insurance.

From a Governmentwide perspective, revenues are expected to fall short of expenditures by approximately \$107.0 billion, which represents the present value of resources needed to sustain the Railroad Retirement Program. From a trust fund perspective, when the trust fund balance and the financial interchange and transfers are included, the combined balance of the NRRIT, the Railroad Retirement Account, and the SSEB Account show a slight surplus.

**Table 8**  
**Present Values of 75-Year Projections of Revenues and Expenditures for the Railroad Retirement Program**<sup>1, 2</sup>

(In billions of present value dollars as of January 1, 2012)

<b>Estimated future income (excluding interest)<sup>3</sup> received from or on behalf of:</b>	
Current participants who have attained retirement age.....	6.6
Current participants not yet having attained retirement age.....	55.6
Those expected to become participants.....	77.9
All participants.....	<u>140.0</u>
<b>Estimated future expenditures:<sup>4</sup></b>	
Current participants who have attained retirement age.....	118.8
Current participants not yet having attained retirement age.....	94.7
Those expected to become participants.....	33.5
All participants.....	<u>247.0</u>
<b>Net obligations from budget perspective (expenditures less income).....</b>	<b>107.0</b>
Railroad Retirement Program assets (mostly investments stated at market) <sup>5</sup> .....	24.2
Financial interchange from Social Security Trust.....	<u>84.2</u>
<b>Net obligations from trust fund perspective.....</b>	<b><u>(1.4)</u></b>

<sup>1</sup> Represents combined values for the Railroad Retirement Account, SSEB Account, and NRRIT, based on middle employment assumption.

<sup>2</sup> The data used reflect the provisions of RRSIA of 2001.

<sup>3</sup> Future income (excluding interest) includes tier I taxes, tier II taxes, and income taxes on benefits.

<sup>4</sup> Future expenditures include benefits and administrative expenditures.

<sup>5</sup> The value of the fund reflects the 7.0 percent interest rate assumption. The RRB uses the relatively high rate due to investments in private securities.

Note: Detail may not add to totals due to rounding. Employee and beneficiary status are determined as of 1/1/2011, whereas present values are as of 1/1/2012.

## Black Lung

The Federal Coal Mine Health and Safety Act of 1969 created the Black Lung Disability Benefit Program to provide compensation, medical, and survivor benefits for eligible coal miners who are totally disabled due to pneumoconiosis (black lung disease) arising out of their coal mine employment. The survivor benefits are available only for eligible survivors of coal miners who died due to pneumoconiosis. DOL operates the Black Lung Disability Benefit Program. The BLDTF provides benefit payments to eligible coal miners totally disabled by pneumoconiosis and to eligible survivors when no responsible mine operator can be assigned the liability. The beneficiary population is a nearly closed universe in which attrition by death exceeds new entrants by a ratio of more than ten to one.

Excise taxes on coal mine operators, based on the sale of coal, are the primary source of financing black lung disability payments and related administrative costs. The Black Lung Benefits Revenue Act provided for repayable advances to the BLDTF from the General Fund of the Treasury, in the event that BLDTF resources were not adequate to meet program obligations. Prior to legislation enacted in 2008 that allowed for the restructuring of BLDTF debt, the trust fund had accumulated large liabilities from significant and growing shortfalls of excise taxes relative to benefit payments and interest expenses.



The Energy Improvement and Extension Act of 2008 (Public Law 110-343), enacted on October 3, 2008, contained several provisions that significantly improved the BLDTF's financial position, including:

- Continuation of a previously-enacted increase in coal excise tax rates for an additional 5 years, through December 2018;
- Provision for the restructuring of BLDTF debt by refinancing the outstanding repayable advances with proceeds from issuing new debt instruments with lower interest rates; and
- Establishment of a one-time appropriation that significantly reduced the outstanding debt of the BLDTF.

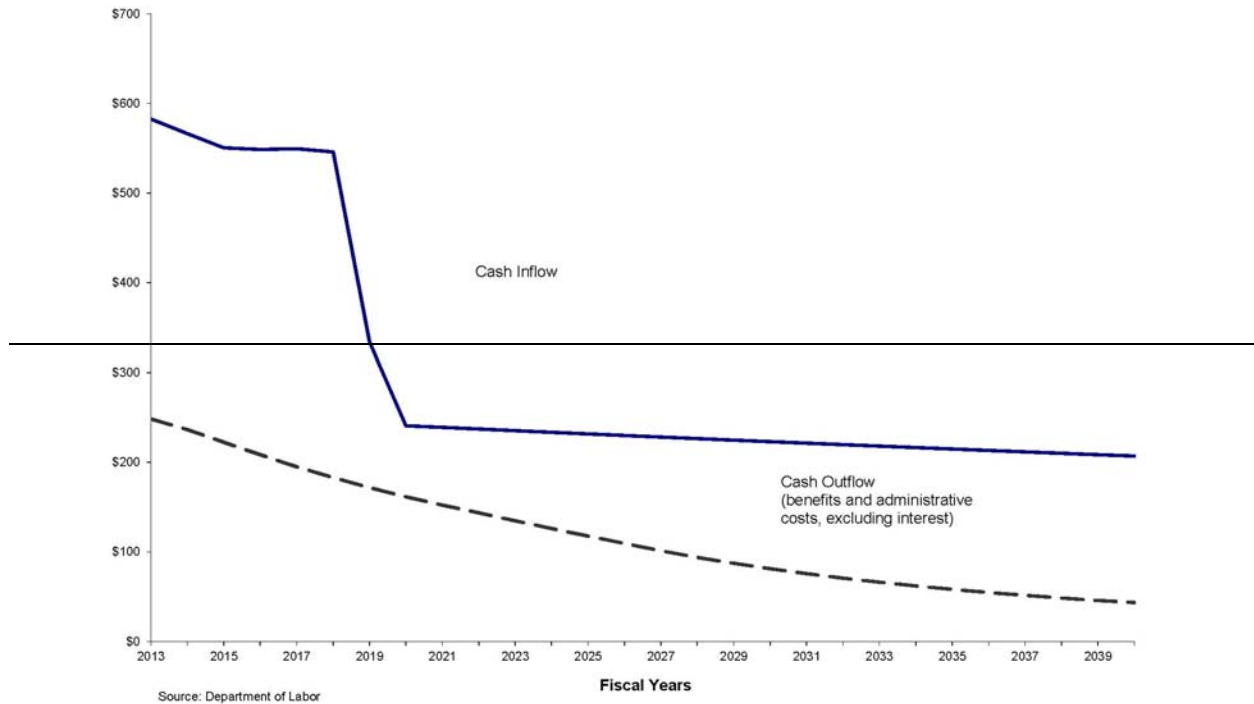
This Act also allowed that any debt issued by the BLDTF subsequent to the refinancing may be used to make benefit payments, other authorized expenditures, or to repay debt and interest from the initial refinancing. All debt issued by the BLDTF was effected as borrowing from the Treasury's Bureau of the Public Debt.

On September 30, 2012, total liabilities of the BLDTF exceeded assets by \$6.0 billion. Prior to the enactment of Public Law 110-343, this shortfall was funded by repayable advances to the BLDTF, which are repayable with interest. Pursuant to Public Law 110-343, any shortfall will be financed with debt instruments similar in form to zero-coupon bonds.

From the budget or consolidated financial perspective, Chart 13 shows projected black lung expenditures (excluding interest) and excise tax collections for the period 2013-2040. The significant assumptions used in the most recent set of projections are shown in the "Black Lung" section of Note 26—Social Insurance. The projected decrease in cash inflows in the year 2019 and, thereafter, is the result of a scheduled reduction in the tax rate on the sale of coal. This rate reduction is projected to result in a 38.8 percent decrease in the amount of excise taxes collected between the years 2018 and 2019.

**Chart 13—Estimated Black Lung Income and Expenditures (Excluding Interest)  
2013-2040**

(In millions of dollars)



**Table 9**  
**Present Values of 28-Year Projections of Expenditures and Revenues**  
**for the Black Lung Disability Benefit Program**

(In billions of present value dollars, as of September 30, 2012)

Projected future expenditures.....	2.7
Projected future tax income.....	6.7
Net obligations from budget perspective (expenditures less income).....	(4.0)
Accumulated balance due General Fund.....	5.7
Net obligations from trust fund perspective .....	1.7

Note: Detail may not add to totals due to rounding.

Source: Department of Labor projections and Treasury Department calculations

Table 9 shows present values of 28-year projections of expenditures and revenues for the Black Lung Disability Benefit Program computed as of September 30, 2012. Cashflows were discounted using the rates on the debt in the BLDTF. From a Governmentwide (budget) perspective, the present value of expenditures is expected to be less than the present value of income by \$4.0 billion (a surplus). From a trust fund perspective, a large balance (\$5.7 billion) is owed to the General Fund. From that perspective, when that accumulated balance is combined with the cashflow surplus, the program has a shortfall of \$1.7 billion in present value dollars. This compares to a shortfall of \$1.9 billion reported in last year’s *Financial Report*.

**Unemployment Insurance**

The Unemployment Insurance Program was created in 1935 to provide temporary partial wage replacement to workers who lost their jobs. The program is administered through a unique system of Federal and State partnerships established in Federal law but administered through conforming state laws by state agencies. The program includes the 50 U.S. states and Puerto Rico, U.S. Virgin Islands, and the District of Columbia. DOL interprets and enforces Federal law requirements and provides broad policy guidance and program direction, while program details such as benefit eligibility, duration, and amount of benefits are established through individual state unemployment insurance statutes and administered through State unemployment insurance agencies.

The program is financed through the collection of Federal and state unemployment taxes that are credited to the UTF and reported as Federal tax revenue. The fund was established to account for the receipt, investment, and disbursement of unemployment taxes. Federal unemployment taxes are used to pay for Federal and state administration of the Unemployment Insurance Program, veterans’ employment services, state employment services, and the Federal share of extended unemployment insurance benefits. Federal unemployment taxes also are used to maintain a loan account within the UTF, from which insolvent state accounts may borrow funds to pay unemployment insurance benefits.

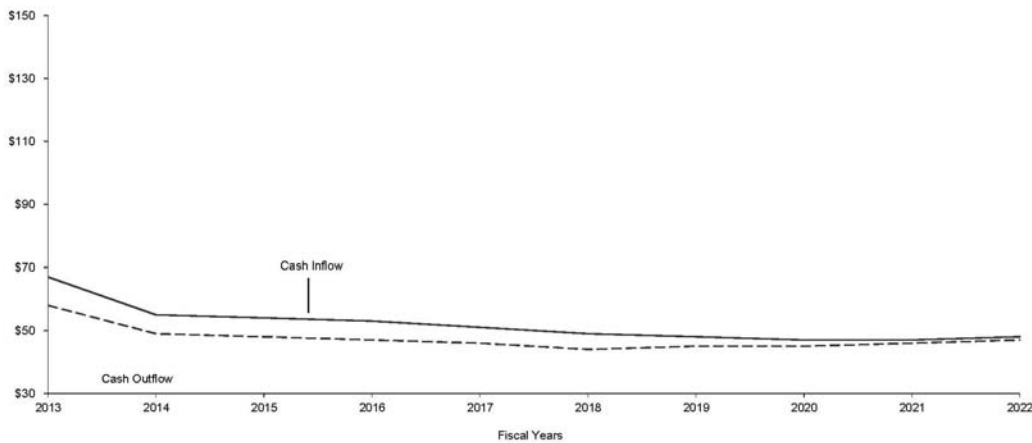
Chart 14 shows the projected cash contributions and expenditures over the next 10 years under expected economic conditions (described below). The significant assumptions used in the projections include total unemployment rates, civilian labor force levels, percent of unemployed receiving benefits, total wages, distribution of benefit payments by State, State tax rate structures, State taxable wage bases, and interest rates on UTF investments. These projections, excluding interest earnings, indicate a negative net cashflow until 2013 followed by positive net cashflow for the remainder of the projection period.

The Worker, Homeownership, and Business Assistance Act of 2009, was enacted on November 6, 2009. This Act extended unemployment benefits to eligible recipients up to 14 additional weeks in all States. It also extended a total of up to 20 additional weeks in States with unemployment of 8.5 percent or greater. It also amended section 3301 of the Internal Revenue Code of 1986 to extend the 0.2 percent Federal Unemployment Tax Act surtax on covered employers through June 30, 2011. No benefits are payable for weeks of unemployment commencing before the date of enactment of the Act.

Public Law 111-205 Unemployment Compensation Extension Act of 2010, enacted on July 22, 2010, amends the Supplemental Appropriation Act, 2008 with respect to the state-established individual emergency unemployment compensation account and to apply to claims for Emergency Unemployment Compensation (EUC) payments the terms and conditions of state unemployment compensation law relating to availability of work, active search for work, and refusal to accept work. The Act extends the final dates for entering a federal-state agreement under the EUC program through November 30, 2010. The Act also postpones the termination of the program until April 30, 2011, and amends the Assistance for Unemployed Workers and Struggling Families Act to extend until December 1, 2010, and requires Federal payments to states cover 100 percent of EUC.

**Chart 14—Estimated Unemployment Trust Fund Cashflow  
Using Expected Economic Conditions  
2013-2022**

(In billions of dollars)



Source: Department of Labor

Table 10 shows present values of 10-year projections of revenues and expenditures for the Unemployment Insurance Program using a discount rate of 3.24 percent, the average of the interest rates underlying the 10-year projections. Three sets of numbers are presented in order to show the effects of varying economic conditions as reflected in different assumptions about the unemployment rate. For expected economic conditions, the estimates are based on an unemployment rate of 7.8 percent during fiscal year 2013, decreasing to below 6 percent in fiscal year 2017 and thereafter. Under Recovery Scenario One (lower than expected unemployment rates), the unemployment rate decreases from 7.31 percent in fiscal year 2013 while net cash inflows peak in fiscal year 2013 and continue to be positive through 2022. Under Recovery Scenario Two, net cash outflows including interest earnings and expenses

are projected in fiscal years 2013 through 2015. Net cash inflows are reestablished in fiscal year 2016 and peak in fiscal year 2018 with a drop in the unemployment rate to 7.65 percent and then lower rates for fiscal years 2019 through 2022.

Each scenario uses an open-group that includes current and future participants of the Unemployment Insurance Program. Table 10 shows the impact on the UTF projections of varying projected unemployment rates. For example, in Recovery Scenario Two, while tax income is projected to increase as higher layoffs result in higher employer taxes, benefit outlays increase even more. From the Governmentwide (budget) perspective, under expected conditions, the present value of income exceeds the present value of expenditures by \$37.5 billion. From the same perspective, under Recovery Scenario Two, the present value of income exceeds the present value of expenditures by \$3.6 billion. From a trust fund perspective, which takes into account the (\$12.9) billion trust fund balance, the program has a surplus of \$24.6 billion under expected conditions. As explained below, the negative trust fund balance reflects loans extended by the General Fund to the states.

**Table 10**  
**Present Values of 10-Year Projections of Expenditures and Revenues for Unemployment Insurance Under Three Alternative Scenarios for Economic Conditions**

(In billions of present value dollars, as of September 30, 2012)

	Economic Conditions		
	Expected	Recovery Scenario One	Recovery Scenario Two
Projected future expenditures.....	403.0	384.3	507.6
Projected future cash income.....	440.5	426.2	511.2
Net obligations from budget perspective (expenditures less income) .....	(37.5)	(41.9)	(3.6)
Trust fund assets .....	(12.9)	(12.9)	(12.9)
Net obligations from trust fund perspective <sup>1</sup> .....	(24.6)	(29.0)	9.3

<sup>1</sup> Net obligations from the trust fund perspective equals net obligations from the budget perspective minus trust fund assets. The negative values in this line are indicative of surpluses.

Note: Detail may not add to totals due to rounding.

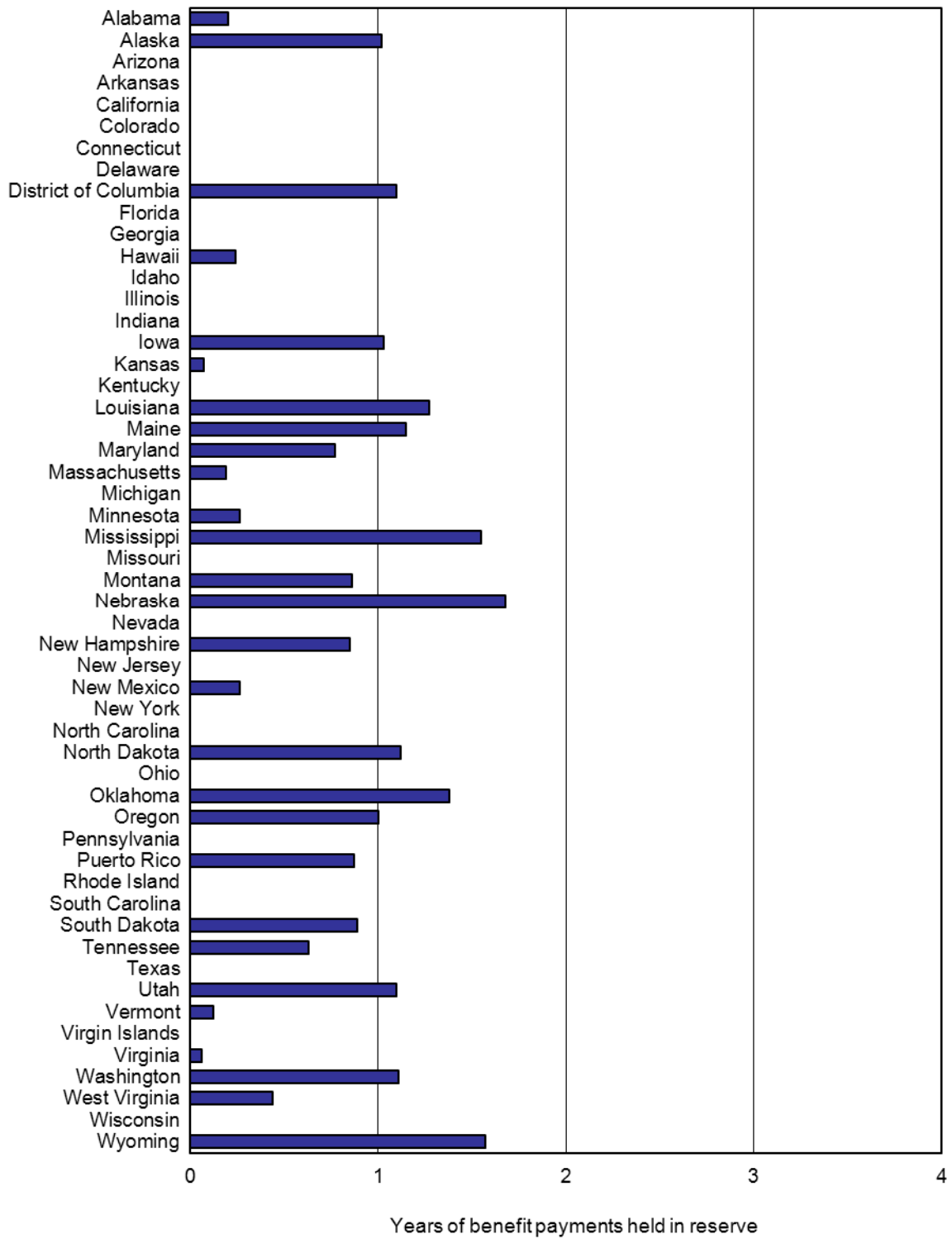
Source: Department of Labor.

**Unemployment Trust Fund Solvency**

Each state’s accumulated UTF net assets or reserve balance should provide a defined level of benefit payments over a defined period. To be minimally solvent, a State’s reserve balance should provide for one year’s projected benefit payment needs based on the highest levels of benefit payments experienced by the State over the last 20 years. A ratio of 1.0 or greater indicates a state is minimally solvent. States below this level are vulnerable to exhausting their funds in a recession. States exhausting their reserve balance borrow funds from the Federal Unemployment Account to make benefit payments.

Chart 15 presents the State by State results of this analysis as of September 30, 2012. As the chart illustrates, 38 state funds plus the funds of Puerto Rico and the Virgin Islands were below the minimal solvency ratio of 1.0 at September 30, 2012.

Chart 15—Unemployment Trust Fund Solvency as of September 30, 2012



## Deferred Maintenance and Repairs

Deferred maintenance and repairs are the estimated cost to bring Government-owned property, plant, and equipment to an acceptable condition, resulting from not performing maintenance on a timely basis. Deferred maintenance and repairs exclude the cost of expanding the capacity of assets or upgrading them to serve needs different from those originally intended. The consequences of not performing regular maintenance and repairs could include increased safety hazards, poor service to the public, higher costs in the future, and inefficient operations. Estimated deferred maintenance and repairs cost are not accrued in the Statements of Net Cost or recognized as a liability on the Balance Sheets.

The amounts disclosed for deferred maintenance and repairs are allowed to be measured using one of the following three methods:

- Condition assessment surveys are periodic inspections of the Government-owned property to determine the current condition and estimated cost to bring the property to an acceptable condition.
- Life-cycle cost forecast is an acquisition or procurement technique that considers operation, maintenance, and other costs in addition to the acquisition cost of assets.
- Management analysis method is founded on inflation-adjusted reductions in maintenance funding since the base year.

The amounts disclosed in the table below have all been measured using the condition assessment survey method. The standards for acceptable operating condition and the changes in these standards and changes in asset condition vary widely between the Federal entities.

Some deferred maintenance and repairs have been deemed critical. Such amounts and conditions are defined by the individual agencies with responsibility for the safekeeping of these assets. The critical maintenance amount is not included in the low or high estimates amounts and is reported separately. Low and high estimates are based on the materiality of the estimated cost of returning the asset to the acceptable condition versus the total value of the corresponding asset.

### Deferred Maintenance and Repairs as of September 30, 2012, and 2011

	Deferred Maintenance and Repairs Cost Range					
	Low Estimate		High Estimate		Critical Maintenance	
	2012	2011	2012	2011	2012	2011
(In billions of dollars)						
<b>Asset category:</b>						
Buildings, structures and facilities .....	31.5	31.3	34.5	36.4	106.3	97.6
Furniture, fixtures and equipment .....	0.1	0.1	0.1	0.1	1.3	2.5
Other general property, plant, and equipment .....	5.3	5.1	5.3	5.1	0.7	0.8
Heritage assets.....	0.9	0.9	0.8	0.9	1.7	1.2
Stewardship land .....	5.8	3.6	8.4	5.2	-	-
Total deferred maintenance ....	<u>43.6</u>	<u>41.0</u>	<u>49.1</u>	<u>47.7</u>	<u>110.0</u>	<u>102.1</u>

Please refer to the individual financial statements of DOI, DOD, USDA, DOE, and VA for detailed significant information on deferred maintenance and repairs, including the standards used for acceptable operating condition and changes in asset condition.

## Other Claims for Refunds

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by appeals. The total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is \$6.1 billion and \$8.1 billion for fiscal years 2012 and 2011, respectively. For those under appeal, the estimated payout is \$5.3 billion and \$7.5 billion for fiscal years 2012 and 2011, respectively. There are also unasserted claims for refunds of certain excise taxes. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheets or for disclosure in the Notes to the Financial Statements. However, they meet the criteria in SFFAS No. 7 for inclusion as Required Supplementary Information. To the extent judgments against the Government for these claims prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

## Tax Assessments

The Government is authorized and required to make inquiries, determinations, and assessments of all taxes that have not been duly paid. Unpaid assessments result from taxpayers filing returns without sufficient payment, as well as enforcement programs such as examination, under-reporter, substitute for return and combined annual wage reporting. Assessments with little or no future collection potential are called write-offs. Although compliance assessments and write-offs are not considered receivables under Federal accounting standards, they represent legally enforceable claims of the Government. There is, however, a significant difference in the collection potential between compliance assessments and receivables.

Compliance assessments and pre-assessment work in process are \$89.6 billion and \$105.0 billion for fiscal years 2012 and 2011, respectively. The amount of allowance for uncollectible amounts pertaining to compliance assessments cannot be reasonably estimated, and thus the net realizable value of the value of the pre-assessment work-in-process cannot be determined. The amount of assessments agencies have statutory authority to collect at the end of the period but that have been written off and excluded from accounts receivable are \$125.1 billion and \$106.6 billion for fiscal years 2012 and 2011, respectively.



## Risk Assumed

Risk assumed information is important for all Federal insurance and guarantee programs, except social insurance, life insurance, and loan guarantee programs. Risk assumed is generally measured by the present value of unpaid expected losses net of associated premiums, based on the risk inherent in the insurance or guarantee coverage in force. In addition to the liability for unpaid insurance claims included in Note 18—Insurance and Guarantee Program Liabilities, for events that have already occurred, the Government also is required to report as supplementary information risk assumed amounts and the periodic changes in those amounts.

The assessments of losses expected based on the risk assumed are based on actuarial or financial methods that include information and assumptions applicable to the economic, legal, and policy environment in force at the time the assessments are made. Management has estimated the loss amounts based on the risk assumed as well as the periodic changes.

Please refer to the individual financial statements of the PBGC, USDA, and NCUA for further detailed information, including information as to the indicators of the range of uncertainty around expected estimates and the indicators of the sensitivity of the estimates to changes in major assumptions. We note that this table does not include all federal insurance and guarantee programs.

<b>Risk Assumed Information as of September 30, 2012, and 2011</b>		
(In billions of dollars)	<b>2012</b>	<b>2011</b>
<b>Present value of unpaid expected losses, net of associated premiums:</b>		
Pension Benefit Guaranty Corporation .....	321.7	250.2
Department of Agriculture .....	18.3	8.8
National Credit Union Administration .....	3.4	7.4
All other .....	0.9	0.9
Total .....	<u>344.3</u>	<u>267.3</u>
<b>Periodic changes in risk assumed amounts:</b>		
Pension Benefit Guaranty Corporation .....	71.5	60.2
Department of Agriculture .....	9.5	1.3
National Credit Union Administration .....	(4.0)	(0.1)
All other .....	-	(1.1)
Total .....	<u>77.0</u>	<u>60.3</u>

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# United States Government Other Accompanying Information (Unaudited) For the Years Ended September 30, 2012, and 2011

## Unexpended Budget Balances

The Federal budget and budget process largely use obligational accounting—a distinct administrative control through which Federal agencies control, monitor, and report on the status of funds at their disposal. Unexpended budget balances consist of the unobligated and obligated, but unliquidated, budget balances.

Unobligated budget balances, including amounts for trust funds, are the cumulative amount of budget balances that are not obligated and that remain available for obligation. In 1-year accounts, the unobligated balance is not available for new obligations after the end of the fiscal year. In multiyear accounts, the unobligated balance may be carried forward and remains available for obligation for the period specified. In no-year accounts, the unobligated balance is carried forward until specifically rescinded by law or the head of the agency concerned determines that the purposes for which it was provided have been accomplished and disbursements have not been made against the appropriation for 2 consecutive years. The total unobligated budget balances as of September 30, 2011, and 2010, are \$829.4 billion and \$885.1 billion, respectively.

Obligated budget balances are the cumulative budget balances that have been obligated but not liquidated. The obligated balance can be carried forward for a maximum of 5 years after the appropriation has expired. The total obligated budget balances as of September 30, 2011, and 2010, are \$1,428.5 billion and \$1,530.9 billion, respectively.

The President's Budget is located at [www.whitehouse.gov/omb](http://www.whitehouse.gov/omb); unexpended budget balances are shown in the supporting documentation section under "Balances of Budget Authority." The President's Fiscal Year 2013 Budget (issued on February 13, 2012) includes the actual unobligated and obligated amounts for fiscal year 2011. The President's Budget with fiscal year 2012 actual amounts is expected to be published in February 2013.

## Tax Burden

The Internal Revenue Code provides for progressive tax rates, whereby higher incomes are generally subject to higher tax rates. The following tables present the latest available information on income tax and related income, deductions, and credit for individuals by income level and for corporations by size of assets.

### Individual Income Tax Liability for Tax Year 2010

Adjusted Gross Income (AGI)	Number of Taxable Returns (In thousands)	AGI (In millions of dollars)	Total Income Tax (In millions of dollars)	Average AGI per Return (In whole dollars)	Average Income Tax per Return (In whole dollars)	Income Tax as a Percentage of AGI
Under \$15,000 .....	37,602	87,421	1,587	2,325	42	1.8%
\$15,000 under \$30,000 .....	30,858	681,419	14,314	22,082	464	2.1%
\$30,000 under \$50,000 .....	25,605	1,000,098	47,754	39,059	1,865	4.8%
\$50,000 under \$100,000 .....	30,533	2,171,323	167,026	71,114	5,470	7.7%
\$100,000 under \$200,000 .....	13,998	1,869,639	224,423	133,565	16,033	12.0%
\$200,000 under \$500,000 .....	3,472	985,431	192,826	283,822	55,537	19.6%
\$500,000 or more .....	825	1,293,811	303,745	1,568,256	368,176	23.5%
Total .....	<u>142,893</u>	<u>8,089,142</u>	<u>951,675</u>			

### Corporation Income Tax Liability for Tax Year 2009

Total Assets (In thousands of dollars)	Income Subject to Tax (In millions of dollars)	Total Income Tax after Credits (In millions of dollars)	Percentage of Income Tax after Credits to Taxable Income
Zero assets .....	45,444	13,840	30.5%
\$1 under \$500 .....	6,280	1,088	17.3%
\$500 under \$1,000 .....	3,273	734	22.4%
\$1,000 under \$5,000 .....	11,116	3,043	27.4%
\$5,000 under \$10,000 .....	6,206	2,002	32.3%
\$10,000 under \$25,000 .....	9,865	3,237	32.8%
\$25,000 under \$50,000 .....	8,968	2,883	32.1%
\$50,000 under \$100,000 .....	12,209	3,925	32.1%
\$100,000 under \$250,000 .....	20,445	6,430	31.5%
\$250,000 under \$500,000 .....	24,838	7,492	30.2%
\$500,000 under \$2,500,000 .....	91,990	26,347	28.6%
\$2,500,000 or more .....	654,215	133,974	20.5%
Total .....	<u>894,849</u>	<u>204,995</u>	

## Tax Gap

The tax gap is the difference between what taxpayers should pay and what they actually pay due to not filing tax returns, not paying their reported tax liability on time, or failing to report their correct tax liability. The tax gap, about \$450.0 billion based on updated fiscal year 2006 estimates, represents the amount of noncompliance with the tax laws. Underreporting of income tax, employment taxes, and other taxes represents 84 percent of the gross tax gap. The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The tax gap arises from three types of noncompliance: not filing required tax returns on time or at all (the nonfiling gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the nonfiling gap and the underreporting gap must be estimated. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Obviously, some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of assessed tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the IRS' balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance).

## Unmatched Transactions and Balances

(In millions of dollars)	<b>Fiscal Year 2012</b>	<b>Fiscal Year 2011</b>
<b>Change in intragovernmental unmatched balances:</b>		
Debt/investment .....	(0.5)	(6.5)
Interest payable/receivable .....	(6.5)	(1.5)
Loans payable/receivable .....	17.6	(27.9)
Benefit program contributions payable/receivable .....	160.8	(44.6)
Accounts payable/receivable .....	(1,267.5)	5,863.4
Advances from/to others and deferred credits/prepayments .....	97.2	416.7
Transfers payable/receivable .....	134.6	14.2
	(864.3)	6,213.8
<b>Unmatched intragovernmental transactions:</b>		
Federal securities interest revenue/expense—investment exchange .....	6.5	1.0
Borrowings interest revenue/expense—exchange .....	71.3	1.4
Borrowings gains/losses .....	9.3	0.4
Nonexpenditure transfers-in/out .....	35.9	(671.0)
Expenditure transfers-in/out .....	122.8	(26.0)
Transfers-in/out without reimbursement .....	(1,013.2)	328.5
Imputed financing source/cost .....	(17.8)	5.3
Benefit program revenue/cost .....	(725.2)	(775.6)
	(1,510.4)	(1,136.0)
<b>General fund transactions:</b>		
Fund balance with Treasury .....	5,656.4	13,671.8
Appropriations of unavailable special or trust fund receipts— transfers-out/in .....	(50.9)	146.1
Appropriations received/warrants .....	2,361.2	(7,486.2)
Other taxes and receipts/trust fund warrants .....	3,588.0	1,862.7
Custodial and non-entity collections transferred out/in .....	(54,161.4)	45,405.0
Other General Fund transactions .....	65,725.2	(45,775.6)
	23,118.5	7,823.8
Net intra-agency reporting errors and restatements .....	(568.4)	2,685.1
Unmatched transactions and balances, net .....	20,175.4	15,586.7

( ) Parentheses indicate a decrease to Net Position.

The Statement of Operations and Changes in Net Position includes an amount for unmatched transactions and balances that result from the consolidation of Federal reporting entities. Transactions between Federal entities must be eliminated in consolidation to calculate the financial position of the U.S. Government. Many of the amounts included in the table represent intragovernmental activity and balances that differed between Federal agency trading partners and often totaled significantly more in the absolute than the net amounts shown. In addition, included in the “General Fund Transactions” section are certain intragovernmental accounts, primarily related to agency unreconciled transactions with the General Fund, totaling hundreds of billions of dollars. The table also reflects other consolidating adjustments and other adjustments that contributed to the unmatched transactions and balances amount.

Unmatched transactions and balances between Federal entities impact not only in the period in which differences originate but also in the periods where differences are reconciled. As a result, it would not be proper to conclude that increases or decreases in the unmatched amounts shown in the “Unmatched Transactions and Balances” table reflect improvements or deteriorations in the Government’s ability to reconcile intragovernmental transactions. The Federal community considers the identification and accurate reporting of intragovernmental activity a priority.

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# United States Government Required Supplementary Stewardship Information (Unaudited) for the Years Ended September 30, 2012, and 2011

## Stewardship Investments

Stewardship investments focus on Government programs aimed at providing long-term benefits by improving the Nation's productivity and enhancing economic growth. These investments can be provided through direct Federal spending or grants to State and local governments for certain education and training programs, research and development, and federally financed but not federally owned property, such as bridges and roads. When incurred, these investments are included as expenses in determining the net cost of operations. Stewardship investments for the current year and for the immediately preceding 4 years are shown below in Table 11.

**Table 11**  
**Stewardship Investments for the Years Ended**  
**September 30, 2008, through 2012**

(In billions of dollars)	Fiscal Year 2012	Fiscal Year 2011	Fiscal Year 2010	Fiscal Year 2009	Fiscal Year 2008
Investments in non-Federal physical property .....	68.1	69.9	66.7	65.1	57.8
Investments in human capital .....	87.1	91.9	122.3	60.3	77.2
<b>Research and development:</b>					
Investments in basic research.....	34.2	35.7	31.5	27.4	27.6
Investments in applied research.....	29.1	28.8	26.2	19.1	21.4
Investments in development.....	67.0	71.7	77.3	101.0	79.2
Total investments.....	<u>285.5</u>	<u>298.0</u>	<u>324.0</u>	<u>272.9</u>	<u>263.2</u>

## Non-Federal Physical Property

The Government makes grants and provides funds for the purchase, construction, and/or major renovation of State and local government physical properties. Costs for non-Federal physical property programs are included as expenses in the Statements of Net Cost and are reported as investments in Table 11. They are measured on the same accrual basis of accounting used in the *Financial Report* statements. DOT, HUD, and EPA had \$56.6 billion (83 percent), \$4.2 billion (6 percent), and \$4.2 billion (6 percent), respectively, of the total non-Federal physical property investments in fiscal year 2012 as shown in Table 11. Within DOT, the Federal Highway Administration invested \$42.6 billion during fiscal year 2012, primarily via reimbursement from the Highway Trust Fund, for States' construction costs of interstate and national highways. The States' contribution is 10 percent for the Interstate System and 20 percent for most other programs.

## Human Capital

The Government runs several programs that invest in human capital. Those investments go toward increasing and maintaining a healthy economy by educating and training the general public. Costs do not include training expenses for Federal workers.

Education, VA, and DOL had \$61.9 billion (71 percent), 12.2 billion (14 percent), and \$6.7 billion (8 percent), respectively, of the total human capital investments in fiscal year 2012 as shown in Table 11. In comparison over the past 5 years, Education had an increase in human capital investments in fiscal years 2008 and 2010, due to an increase in the net cost for the Federal Family Education Loan, Direct Loan, Grant Programs, and Other Programs, including the *American Recovery and Reinvestment Act of 2009*; while VA increased in fiscal years 2009 through 2012 due to implementation of the Post 9/11 GI Bill. Education administers a wide variety of programs related to general public education and training programs that are intended to increase or maintain national economic productive capacity. The Office of Federal Student Aid administers need-based financial assistance programs for students pursuing postsecondary education and makes available Federal grants, direct loans, and work-study funding to eligible undergraduate and graduate students.

The significant human capital programs administered by DOL relate to grants for job training and employment programs. The significant human capital programs administered by VA also relate to grants for job training and rehabilitation programs for veterans.

## Research and Development

Federal investments in Research and Development (R&D) comprise those expenses for basic research, applied research, and development that are intended to increase or maintain national economic productive capacity or yield other future benefits.

- Investments in basic research are for systematic studies to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications toward processes or products in mind.
- Investments in applied research are for systematic studies to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met.
- Investments in development are the systematic use of the knowledge and understanding gained from research for the production of useful materials, devices, systems, or methods, including the design and development of prototypes and processes.

With regard to basic and applied research, HHS had \$ 18.5 billion (54 percent) and \$ 13.1 billion (45 percent), of the total basic and applied research investments, respectively, in fiscal year 2012 as shown in Table 11. HHS also had similar R&D investment amounts (and percentage contributions) in each of the preceding 4 years.

Within HHS, the National Institutes of Health (NIH) conducts almost all (98 percent) of the Department's basic and applied research. The NIH Research Program includes all aspects of the medical research continuum, including basic and disease-oriented research, observational and population-based research, behavioral research, and clinical research, including research to understand both health and disease states, to move laboratory findings into

medical applications, to assess new treatments or compare different treatment approaches; and health services research.

The NIH regards the expeditious transfer of the results of its medical research for further development and commercialization of products of immediate benefit to improved health as an important mandate.

With regard to development, the DOD and NASA had \$ 59.7 billion (89 percent) and \$3.6 billion (5 percent), respectively, of total development investments in fiscal year 2012, as shown in Table 11. Development is comprised of five stages: advanced technology development, advanced component development and prototypes, system development and demonstration, management support, and operational systems development. Major outputs of DOD development are:

- Hardware and software components, and complete weapon systems ready for operational and developmental testing and field use, and
- Weapon systems finalized for complete operational and developmental testing.

NASA development includes activities to extend our knowledge of Earth, its space environment, and the universe, and to invest in new aeronautics and advanced space transportation technologies that support the development and application of technologies critical to the economic, scientific, and technical competitiveness of the United States.

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## Appendix A: Reporting Entity

This appendix lists the organizations and agencies encompassed in the reporting entity for this publication as well as some organizations excluded from the reporting entity. The reporting entity is a specifically defined group of agencies, principally Cabinet departments and other agencies of the executive branch, as stated in the law and accounting guidance.

The determination as to which organizations and agencies will be included in the reporting entity is governed by Federal laws and is also based on guidance issued by the Federal Accounting Standards Advisory Board (the Board) in their Statement of Federal Financial Accounting Concept No. 2, Entity and Display, which provides criteria for determining what should be included in the reporting entity for a consolidated Governmentwide report. The Board is now considering more specific guidance on the reporting entity for this report.

There are a total of 150 organizations and agencies included in the *Financial Report of the United States Government*. The lists below describe three groups of entity/fund types that comprise the reporting entity for the *Financial Report* and include entities from all three branches of Government.

### Twenty-Four Chief Financial Officer Act Agencies

Department of Agriculture  
[www.usda.gov](http://www.usda.gov)

Department of Commerce  
[www.doc.gov](http://www.doc.gov)

Department of Defense  
[www.defense.gov](http://www.defense.gov)

Department of Education  
[www.ed.gov](http://www.ed.gov)

Department of Energy  
[www.doe.gov](http://www.doe.gov)

Department of Health and Human Services  
[www.hhs.gov](http://www.hhs.gov)

Department of Homeland Security  
[www.dhs.gov](http://www.dhs.gov)

Department of Housing and Urban Development  
[www.hud.gov](http://www.hud.gov)

Department of the Interior  
[www.doi.gov](http://www.doi.gov)

Department of Justice  
[www.usdoj.gov](http://www.usdoj.gov)

Department of Labor  
[www.dol.gov](http://www.dol.gov)

Department of State  
[www.state.gov](http://www.state.gov)

Department of Transportation  
[www.dot.gov](http://www.dot.gov)

Department of the Treasury  
[www.treasury.gov](http://www.treasury.gov)

Department of Veterans Affairs  
[www.va.gov](http://www.va.gov)

Environmental Protection Agency  
[www.epa.gov](http://www.epa.gov)

General Services Administration  
[www.gsa.gov](http://www.gsa.gov)

National Aeronautics and Space Administration  
[www.nasa.gov](http://www.nasa.gov)

National Science Foundation  
[www.nsf.gov](http://www.nsf.gov)

Office of Personnel Management  
[www.opm.gov](http://www.opm.gov)

Small Business Administration  
[www.sba.gov](http://www.sba.gov)

Social Security Administration  
[www.ssa.gov](http://www.ssa.gov)

U.S. Agency for International Development  
[www.usaid.gov](http://www.usaid.gov)

U.S. Nuclear Regulatory Commission  
[www.nrc.gov](http://www.nrc.gov)

## Eleven Additional Significant Entities

Export-Import Bank of the United States  
www.exim.gov

Farm Credit System Insurance Corporation  
www.fcsic.gov

Federal Communications Commission  
www.fcc.gov

Federal Deposit Insurance Corporation  
www.fdic.gov

National Credit Union Administration  
www.ncua.gov

Pension Benefit Guaranty Corporation  
www.pbgc.gov

Railroad Retirement Board  
www.rrb.gov

Securities and Exchange Commission  
www.sec.gov

Smithsonian Institution  
www.si.edu

Tennessee Valley Authority  
www.tva.gov

U.S. Postal Service  
www.usps.gov

## One Hundred Fifteen Additional Entities/Funds

Abraham Lincoln Bicentennial Commission\*

Administrative Conference of the United States

Advisory Council on Historic Preservation

African Development Foundation

American Battle Monuments Commission

Antitrust Modernization Commission\*

Appalachian Regional Commission

Architect of the Capitol

Architectural and Transportation Barriers Compliance Board

Armed Forces Retirement Home

Barry Goldwater Scholarship and Excellence in Education Foundation

Broadcasting Board of Governors

Bureau of Consumer Financial Protection

Central Intelligence Agency

Chemical Safety Hazard Investigation Board

Christopher Columbus Fellowship Foundation

Commission for the Preservation of America's Heritage Abroad

Commission of Fine Arts

Commission on Civil Rights

Commission on International Religious Freedom

Commission on Security and Cooperation in Europe

Commission on Weapons of Mass Destruction\*

Committee for Purchase from People Who Are Blind or Severely Disabled

Commodity Futures Trading Commission

Congressional Budget Office

Congressional-Executive Commission on the People's Republic of China

Consumer Product Safety Commission

Corporation for National and Community Service

Council of the Inspectors General on Integrity and Efficiency

Court of Appeals for Veterans Claims

Court Services and Offender Supervision Agency for DC

DC Courts

DC Courts–Defender Services

Defense Nuclear Facilities Safety Board

Delta Regional Authority

Denali Commission

Dwight D. Eisenhower Memorial Commission

Eisenhower Exchange Fellowship Program

Election Assistance Commission

Environmental Dispute Resolution Fund

Equal Employment Opportunity Commission

Executive Office of the President

Farm Credit Administration

Federal Election Commission

Federal Financial Institutions Examination Council Appraisal Subcommittee

Federal Housing Finance Agency

Federal Labor Relations Authority

Federal Maritime Commission

Federal Mediation and Conciliation Service

Federal Mine Safety and Health Review Commission

Federal Trade Commission

Financial Crisis Inquiry Commission\*

Foreign Military Sales Program

Government Accountability Office

Government Printing Office

Harry S. Truman Scholarship Trust Fund

Indian Law and Order Commission

Institute of American Indian and Alaska Native Culture and Arts Development

Institute of Museum and Library Services

Interagency Council on the Homeless

Inter-American Foundation

International Trade Commission

James Madison Memorial Fellowship Foundation

Japan-United States Friendship Commission

John C. Stennis Center	Office of Navajo and Hopi Indian Relocation
John F. Kennedy Center for the Performing Arts	Office of Special Counsel
Library of Congress	Office of the Director of National Intelligence
Marine Mammal Commission	Office of the Federal Coordination for Alaska Natural Gas Transportation Projects
Medicaid and Children's Health Insurance Program Payment and Access Commission	Office of the Nuclear Waste Negotiator*
Medicare Payment Advisory Commission	Open World Leadership Center
Merit Systems Protection Board	Overseas Private Investment Corporation
Millennium Challenge Corporation	Patient Centered Outcomes Research Trust Fund
Morris K. Udall Scholarship Foundation	Peace Corps
National Archives and Records Administration	Presidio Trust
National Capital Planning Commission	Public Defender Service
National Commission on Libraries and Information Science*	Ronald Reagan Centennial Commission
National Council on Disability	Recovery Act Accountability and Transparency Board
National Endowment for the Arts	Selective Service System
National Endowment for the Humanities	Senate Preservation Fund
National Gallery of Art	St. Lawrence Seaway Development Corporation
National Labor Relations Board	State Justice Institute
National Mediation Board	U.S. Capital Preservation Commission
National Railroad Retirement Investment Trust	U.S. China Security Review Commission
National Transportation Safety Board	U.S. Holocaust Memorial Museum
Neighborhood Reinvestment Corporation	U.S. Institute of Peace
Northern Border Regional Commission	U.S. Trade and Development Agency
Nuclear Waste Technical Review Board	Vietnam Education Foundation
Occupational Safety and Health Review Commission	White House Commission on the National Moment of Remembrance*
Office of Compliance	Woodrow Wilson International Center for Scholars
Office of Government Ethics	

\*These entities are no longer active and have either returned all remaining fund balances to Treasury during fiscal year 2012 or have remaining fund balances pending final return to Treasury as of September 30, 2012.

### Legislative and Judicial Branches

There are no legal or other requirements for the legislative or judicial branches to prepare consolidated audited financial statements or to provide accrual-based accounting data for inclusion in the Governmentwide financial statements. Therefore, these consolidated statements do not include accrual-based accounting data for such entities as the U.S. Courts or the Congress. Some legislative branch entities voluntarily prepare and submit such information (e.g., Government Accountability Office, Government Printing Office, and Library of Congress). The President's Budget includes cash-based outlay data for the legislative and judicial branches and, to a limited extent, this outlay data is also a part of the information contained in this report.

### Entities Excluded from These Statements

The following entities are not part of the Governmentwide reporting entity based on an assessment of these entities in accordance with the indicative criteria stated in SFFAC No. 2, Entity and Display. However, this list is not all inclusive of all entities excluded from these statements.

American International Group (AIG)	Thrift Savings Fund
Board of Governors of the Federal Reserve System (Including the Federal Reserve Banks)	The Financing Corporation
Citigroup	GMAC Financial (Ally Financial)
Federal Home Loan Banks	National Railroad Passenger Corporation (does business as Amtrak)
Federal Home Loan Mortgage Corporation (Freddie Mac)	Public-Private Investment Funds
Federal National Mortgage Association (Fannie Mae)	Resolution Funding Corporation
	Student Loan Marketing Association

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## Appendix B: Acronyms

This appendix lists the acronyms used in the Financial Statements and Notes to the Financial Statements section of this *Financial Report*.

ABS	Asset-Backed Securities
ACA	Affordable Care Act
ACH	Automated Clearinghouse
AIFP	Automotive Industry Financing Program
AIG	American International Group, Inc.
AMT	Alternative Minimum Tax
ARRA	American Recovery and Reinvestment Act of 2009
ASC	Accounting Standards Codification
ATRA	American Taxpayer Relief Act of 2012
BLDTF	Black Lung Disability Trust Fund
CCC	Commodity Credit Corporation
CDCI	Community Development Capital Initiative
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CMS	Centers for Medicare and Medicaid Services
COLA	Cost of Living Adjustments
CPI	Consumer Price Index
CPIM	Consumer Price Index–Medical
CPP	Capital Purchase Program
CSRDF	Civil Service Retirement and Disability Fund
CSRS	Civil Service Retirement System
DHS	Department of Homeland Security
DI	Disability Insurance
DIF	Deposit Insurance Fund
DIP	Debtor in Possession
DOC	Department of Commerce
DOD	Department of Defense
DOE	Department of Energy
DOI	Department of the Interior
DOJ	Department of Justice
DOL	Department of Labor
DOT	Department of Transportation
Education	Department of Education
EESA	Emergency Economic Stabilization Act of 2008
EPA	Environmental Protection Agency
EOP	Executive Office of the President
ESF	Exchange Stabilization Fund
EUC	Unemployment Account
EUCA	Emergency Unemployment Compensation Account
Ex-Im Bank	Export-Import Bank
FAA	Federal Aviation Administration
Fannie Mae	Federal National Mortgage Association
FASAB	Federal Accounting Standards Advisory Board
FCC	Federal Communications Commission
FCRA	Federal Credit Reform Act of 1991
FDIC	Federal Deposit Insurance Corporation
FECA	Federal Employees' Compensation Act
FEGLI	Federal Employees' Group Life Insurance
FEHB	Federal Employees Health Benefits Program
FERS	Federal Employees' Retirement System

FERSA	Federal Employees' Retirement System Act of 1986
FFAS	Farm and Foreign Agricultural Services
FFEL	Federal Family Education Loan
FHA	Federal Housing Administration
FHFA	Federal Housing Financing Agency
FHWA	Federal Highway Administration
FICA	Federal Insurance Contribution Act
FR	Financial Report of the United States Government
FR System	Federal Reserve System
FRBNY	Federal Reserve Bank of New York
FRBs	Federal Reserve banks
Freddie Mac	Federal Home Loan Mortgage Corporation
FRTIB	Federal Retirement Thrift Investment Board
FSA	Farm Service Agency
FUA	Federal Unemployment Account
FUTA	Federal Unemployment Tax Act
GAAP	U.S. Generally Accepted Accounting Principles
GAO	U.S. Government Accountability Office
GDP	Gross Domestic Product
Ginnie Mae	Government National Mortgage Association
GM	General Motors
GSA	General Services Administration
GSE	Government-Sponsored Enterprises
HBP	Health Benefits Program
HEA	Higher Education Act of 1965
HERA	Housing and Economic Recovery Act of 2008
HFA	Housing Financing Agencies
HHS	Department of Health and Human Services
HI	Hospital Insurance
HUD	Department of Housing and Urban Development
IMF	International Monetary Fund
IRS	Internal Revenue Service
LAC	Latest Acquisition Cost
MAC	Moving Average Cost
MBS	Mortgage-Backed Securities
MDBs	Multilateral Development Banks
MERHCF	Medicare Eligible Retiree Health Care Fund
MMA	Medicare Prescription Drug, Improvement, and Modernization Act
MRF	Military Retirement Fund
NAB	New Arrangement to Borrow
NASA	National Aeronautics and Space Administration
NCUA	National Credit Union Administration
NIH	National Institutes of Health
RRRIT	National Railroad Retirement Investment Trust
NSLI	National Service Life Insurance
NTIA	National Telecommunications and Information Administration
NYSE	New York Stock Exchange
OASDI	Old-Age, Survivors, and Disability Insurance
OASI	Old-Age and Survivors Insurance
OMB	Office of Management and Budget
OPEB	Other Postemployment Benefits
OPM	Office of Personnel Management
ORB	Other Retirement Benefits
PBGC	Pension Benefit Guaranty Corporation
PCF	Periodic Commitment Fee
PEFCO	Private Export Funding Corporation

PMA	Power Marketing Authorities
PP&E	Property, Plant, and Equipment
PPIF	Public Private Investment Funds
PPIP	Public Private Investment Program
PPO	Preferred Provider Organization
PSRHB	Postal Service Retiree Health Benefits
QFI	Qualified Financial Institution
R&D	Research and Development
RCRA	Resource Conservation and Recovery Act
RD	Rural Development
REDUX	Military Retirement Reform Act of 1986
RRB	Railroad Retirement Board
RRSIA	Railroad Retirement and Survivors Improvement Act
RSI	Required Supplementary Information
SAFETEA-LU	Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users
SAFRA	Student Aid and Fiscal Responsibility Act
Sallie Mae	Student Loan Marketing Association
SBA	Small Business Administration
SCSIA	Statement of Changes in Social Insurance Amounts
SDRs	Special Drawing Rights
SDRCs	SDR Certificates
SEC	Securities and Exchange Commission
SECA	Self-Employment Contributions Act
SFFAC	Statement of Federal Financial Accounting Concept
SFFAS	Statement of Federal Financial Accounting Standards
SFP	Supplementary Financing Program
SLMA	Student Loan Marketing Association
SMI	Supplementary Medical Insurance
SOMA	System Open Market Account
SOSI	Statement of Social Insurance
SPSPA	Senior Preferred Stock Purchase Agreements
SSA	Social Security Administration
SSEB	Social Security Equivalent Benefit
TALF	Term Asset-Backed Loan Facility
TARP	Troubled Asset Relief Program
TFL	TRICARE for Life
TIP	Targeted Investment Program
TIPS	Treasury Inflation-Protected Securities
TPTCCA	Temporary Payroll Tax Cut Continuation Act of 2011
Treasury	Department of the Treasury
TRIA	Terrorism Risk Insurance Act
TSP	Thrift Savings Plan
TVA	Tennessee Valley Authority
TVARS	Tennessee Valley Authority Retirement System
U.S.C.	United States Code
USDA	United States Department of Agriculture
USPS	United States Postal Service
UTF	Unemployment Trust Fund
VA	Department of Veterans Affairs
VRI	Veterans Reopened Insurance
VSLI	Veterans Special Life Insurance

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**United States Government Accountability Office**  
**Washington, DC 20548**

## **Independent Auditor's Report**

The President  
The President of the Senate  
The Speaker of the House of Representatives

The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, is required to annually submit audited financial statements for the U.S. government to the President and Congress. GAO is required to audit these statements.<sup>1</sup> This report includes (1) our report on the accompanying U.S. government's accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011; the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts and (2) our associated reports on internal control over financial reporting and on compliance with selected provisions of laws and regulations. As used in this report, accrual-based financial statements refer to all of the consolidated financial statements and notes, except for those related to the Statements of Social Insurance and the Statements of Changes in Social Insurance Amounts.<sup>2</sup>

Management of the federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP); (2) establishing, maintaining, and evaluating internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met;<sup>3</sup> and (3) complying with laws and regulations. Also, the 24 Chief Financial Officers (CFO) Act agencies are responsible for implementing and maintaining financial management

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<sup>1</sup>The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331(e). The federal government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.

<sup>2</sup>The accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011, consist of the (1) Statements of Net Cost, (2) Statements of Operations and Changes in Net Position, (3) Reconciliations of Net Operating Cost and Unified Budget Deficit, (4) Statements of Changes in Cash Balance from Unified Budget and Other Activities, and (5) Balance Sheets, including the related notes to these financial statements. Most revenues are recorded on a modified cash basis. The 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance, and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, including the related notes, are also included in the consolidated financial statements. Both the Statements of Social Insurance and the Statement of Changes in Social Insurance Amounts do not interrelate with the accrual-based consolidated financial statements.

<sup>3</sup>31 U.S.C. 3512 (c), (d) (commonly referred to as FMFIA). This act requires executive agency heads to evaluate and report annually to the President and Congress on the adequacy of their internal control and accounting systems and on actions to correct significant problems.

systems that substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).<sup>4</sup> Appendix I discusses the objectives, scope, and methodology of our work.

In summary, we found the following:

- Certain material weaknesses<sup>5</sup> in internal control over financial reporting and other limitations on the scope of our work resulted in conditions that continued to prevent us from expressing an opinion on the accompanying accrual-based consolidated financial statements for the fiscal years ended September 30, 2012 and 2011.<sup>6</sup>
- Significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, prevented us from expressing an opinion on those statements as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts. The Statements of Social Insurance for 2009 and 2008 are presented fairly, in all material respects, in conformity with U.S. GAAP.<sup>7</sup>
- Material weaknesses resulted in ineffective internal control over financial reporting for fiscal year 2012.
- Our tests of compliance with selected provisions of laws and regulations for fiscal year 2012 were limited by the material weaknesses and other scope limitations discussed in this report.

### Significant Matters of Emphasis

Before discussing our conclusions on the consolidated financial statements, the following key items deserve emphasis in order to put the information contained in the consolidated financial statements and the Management's Discussion and Analysis section of the *2012 Financial Report of the United States Government (2012 Financial Report)* into context.

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<sup>4</sup>FFMIA, which is reprinted in 31 U.S.C. 3512 note.

<sup>5</sup>A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

<sup>6</sup>We previously reported that certain material weaknesses prevented us from expressing an opinion on the accrual-based consolidated financial statements of the U.S. government for fiscal years 1997 through 2011. Also for these years, we previously reported that (1) material weaknesses resulted in ineffective internal control over financial reporting, and (2) our tests of compliance with selected provisions of laws and regulations were limited by material weaknesses and, for some years, other scope limitations.

<sup>7</sup>The valuation date is January 1 for all social insurance programs except the Black Lung program, which has a valuation date of September 30.

## The Federal Government's Actions to Stabilize Financial Markets and to Promote Economic Recovery

The accrual-based consolidated financial statements for fiscal year 2012 include, as they did for fiscal year 2011, substantial assets and liabilities resulting from the federal government's actions to stabilize financial markets and to promote economic recovery. Key actions that the federal government has taken to stabilize financial markets and to promote economic recovery are discussed in the related Notes to the consolidated financial statements.

The ultimate cost of all of the federal government's market stabilization and economic recovery actions and the effect of such actions on its financial condition will not be known for some time. As of September 30, 2012, the federal government's actions to stabilize the financial markets and to promote economic recovery resulted in reported federal government assets of over \$152 billion (e.g., investments in the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac),<sup>8</sup> and the Troubled Asset Relief Program (TARP) equity investments)<sup>9</sup> (reported net of about \$109 billion in valuation losses). In addition, the federal government reported incurring certain liabilities resulting from these actions. In valuing these and certain other assets and liabilities, management considered and selected assumptions and data that it believed provided a reasonable basis for the estimated values reported in the accrual-based consolidated financial statements. However, as discussed in Note 1 to the consolidated financial statements, there are many factors affecting these assumptions and estimates that are inherently subject to substantial uncertainty arising from the uniqueness of certain transactions and the likelihood of future changes in general economic, regulatory, and market conditions. As such, there will be differences between the estimated values as of September 30, 2012, and the actual results, and such differences may be material. These differences will also affect the ultimate cost of the federal government's actions.

## Long-Term Fiscal Challenges

Increased attention to risks that could affect the federal government's financial condition is made more important because of the nation's longer-term fiscal challenges. The comprehensive long-term fiscal projections presented in the unaudited Required Supplementary Information section of the *2012 Financial Report* show that—absent policy changes—the federal government continues to face an unsustainable fiscal path. The oldest members of the baby-boom generation are already eligible for Social Security retirement benefits and for Medicare benefits. Under these projections, spending for the major health and retirement programs will increase in coming decades as more members of the baby-boom generation become eligible for benefits and the health care cost for each enrollee increases. Over the long term, the structural imbalance between spending and revenue will lead to continued growth of debt held by the public as a share of gross domestic product (GDP); this means the current structure of the federal budget is unsustainable.

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<sup>8</sup>The Housing and Economic Recovery Act of 2008 authorized the Department of the Treasury (Treasury) to purchase, until December 31, 2009, any amount of Fannie Mae or Freddie Mac securities, whether debt or equity. Pub. L. No. 110-289, § 1117, 112 Stat. 2654, 2683-88 (July 30, 2008).

<sup>9</sup>TARP was established by Treasury under authority provided in the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008). The act requires the U.S. Comptroller General to annually audit TARP's financial statements as well as report at least every 60 days on a variety of areas associated with oversight of TARP. To obtain copies of the TARP financial statement audits and the 60-day reports, see GAO's website at <http://www.gao.gov/docsearch/featured/financialmarketsandhousing.html>.

These projections, with regard to Social Security and Medicare, are based on the same assumptions underlying the information presented in the Statement of Social Insurance and assume that the provisions in law designed to slow the growth of Medicare costs are sustained and remain effective throughout the projection period. If, however, the cost containment measures are not sustained over the long term—a concern expressed by the Trustees of the Medicare trust funds, the Centers for Medicare & Medicaid Services' (CMS) Chief Actuary, the Congressional Budget Office, and others—spending on federal health care programs will grow much more rapidly. GAO also prepares long-term federal fiscal simulations which continue to show debt rising as a share of GDP.<sup>10</sup> Under GAO's Alternative simulation,<sup>11</sup> which uses the CMS Office of the Actuary's alternative health care cost projections, future spending in excess of receipts would be greater and debt held by the public as a share of GDP would grow more quickly than the projections in the *2012 Financial Report*.

In January 2013, the American Taxpayer Relief Act of 2012 was enacted,<sup>12</sup> which affected taxes and made some changes to the Budget Control Act of 2011.<sup>13</sup> Congress will be considering further legislative changes to address the fiscal challenges.

### Equity Interests in Certain Financial Organizations and Commercial Entities

As discussed in Note 1 to the consolidated financial statements, the financial statements do not include the assets, liabilities, or results of operations of any financial organizations or commercial entities in which the Department of the Treasury (Treasury) holds either a direct, indirect, or beneficial equity interest. Treasury and the Office of Management and Budget (OMB) have determined that none of these organizations or entities meet the criteria for a federal entity. The federal government's investments in and any liabilities to such organizations and entities, however, are valued and reported on the Balance Sheet.

### **Disclaimers of Opinion on the Accrual-Based Consolidated Financial Statements**

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. government's accompanying accrual-based consolidated financial statements for fiscal years 2012 and 2011, principally resulting from limitations related to certain material weaknesses in internal control over financial reporting and other limitations on the scope of our work, we are unable to, and we do not, express an opinion on such accrual-based consolidated financial statements. As a result of these limitations, readers are cautioned that amounts reported in the accrual-based consolidated financial statements and related notes may not be reliable.

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<sup>10</sup>GAO, *The Federal Government's Long-Term Fiscal Outlook: Fall 2012 Update*, GAO-13-148SP (Washington, D.C.: Dec. 3, 2012).

<sup>11</sup>GAO's Fall 2012 Alternative simulation incorporates the CMS Office of the Actuary's alternative projections for health care cost growth, which assume physician payments are not reduced as specified under current law and certain cost controls are not maintained over the long term. Also in this simulation, expiring tax provisions other than the Social Security payroll tax reductions are extended to 2022 and the alternative minimum tax exemption amount is indexed to inflation through 2022. In the Alternative simulation, discretionary spending follows the original discretionary spending caps set by the Budget Control Act of 2011, but not the lower caps triggered by the automatic enforcement procedures. Over the long term, discretionary spending and revenue are held at their historical average share of GDP.

<sup>12</sup>The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (Jan. 2, 2013).

<sup>13</sup>The Budget Control Act of 2011, Pub. L. No. 112-25, § 302, 125 Stat. 240, 256-59 (Aug. 2, 2011).



The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the accompanying accrual-based consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. Specifically, these weaknesses concerned the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the accrual-based consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the reported total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain federal entities;
- adequately account for and reconcile intragovernmental activity and balances between federal entities;
- ensure that the federal government's accrual-based consolidated financial statements were (1) consistent with the underlying audited entities' financial statements, (2) properly balanced, and (3) in conformity with U.S. GAAP; and
- identify and either resolve or explain material differences between (1) certain components of the budget deficit reported in Treasury's records that are used to prepare the Reconciliation of Net Operating Cost and the Unified Budget Deficit, the Statement of Changes in Cash Balance from Unified Budget and Other Activities, and the Fiscal Projections for the U.S. Government (included in the unaudited Required Supplementary Information section of the *2012 Financial Report*) and (2) related amounts reported in federal entities' financial statements and underlying financial information and records.

These material weaknesses continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) hinder the federal government from having reliable financial information to operate in an efficient and effective manner. Due to these material weaknesses and to other limitations on the scope of our work discussed below, additional issues may exist that could affect the accrual-based consolidated financial statements that were not identified. Appendix II describes these material weaknesses in more detail and highlights the primary effects of these material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

## **Disclaimers of Opinion on the Statements of Social Insurance for 2012, 2011, and 2010, and Unqualified Opinions for 2009 and 2008, and Disclaimers of Opinion on the Statements of Changes in Social Insurance Amounts for 2012 and 2011**

Because of significant uncertainties (discussed in Note 26 to the consolidated financial statements), primarily related to the achievement of projected reductions in Medicare cost growth reflected in the 2012, 2011, and 2010 Statements of Social Insurance, we were unable to obtain sufficient evidence to support the amounts presented in the 2012, 2011, and 2010 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts. Consequently, we are unable to, and we do not, express opinions on the 2012, 2011, and 2010 Statements of Social Insurance as well as on the 2012 and 2011 Statements of Changes in Social Insurance Amounts.

These significant uncertainties include the following.

- Medicare projections in the 2012, 2011, and 2010 Statements of Social Insurance were based on benefit formulas in current law and included a significant decrease in projected Medicare costs from the 2009 Statement of Social Insurance related to (1) reductions in Medicare payment rates for physician services (totaling almost 31 percent in January 2013, as estimated in the 2012 Medicare Trustees Report) and (2) productivity improvements for most other categories of Medicare providers, based on full implementation of the provisions of the Patient Protection and Affordable Care Act, as amended (PPACA).<sup>14</sup> However, there are significant uncertainties concerning the achievement of these projected decreases in Medicare costs.
- Management has noted that actual future costs for Medicare are likely to exceed those shown by the current-law projections presented in the 2012, 2011, and 2010 Statements of Social Insurance due, for example, to the likelihood of modifications to the scheduled reductions in Medicare payment rates for physician services.<sup>15</sup> The extent to which actual future costs exceed the projected current-law amounts due to changes to the scheduled reductions in Medicare payment rates for physician services and productivity adjustments depends on both the specific changes that might be legislated and whether such legislation would include further provisions to help offset such costs.
- Management has developed an illustrative alternative projection intended to provide additional context regarding the long-term sustainability of the Medicare program and to illustrate the uncertainties in the Statement of Social Insurance projections. The present value of future estimated expenditures in excess of future estimated revenue for Medicare, included in the illustrative alternative projection, exceeds the \$27.2 trillion estimate in the 2012 Statement of Social Insurance by \$10.1 trillion.

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<sup>14</sup>PPACA, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

<sup>15</sup>Statutes have been enacted with provisions that prevented scheduled reductions in Medicare payment rates for physician services from taking effect from 2003 through 2013, including the most recent provision enacted in the American Taxpayer Relief Act of 2012. Some of these statutes also included provisions that reduced the federal government's spending on other categories of health care, which had the effect of helping to offset the increased costs related to the physician payment updates.

Projections of Medicare costs are sensitive to assumptions about future decisions by policymakers and about the behavioral responses of consumers, employers, and health care providers as policy, incentives, and the health care sector change over time. Such secondary impacts are not fully reflected in the Statement of Social Insurance projections but could be expected to influence the excess cost growth rate<sup>16</sup> used in the projections. Key drivers of uncertainty about the excess cost growth rate include the future development and deployment of medical technology, the evolution of personal income, and the cost and availability of insurance, as well as federal policy changes, such as the implementation of PPACA. The work of the 2010 Medicare Technical Review Panel<sup>17</sup> may provide additional guidance to management concerning ways to improve future Statement of Social Insurance projections and related disclosures.

As a result of the uncertainties discussed previously, readers are cautioned that amounts reported in the 2012, 2011, and 2010 Statements of Social Insurance and related Notes to such financial statements may not fairly present, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with U.S. GAAP. These uncertainties also affect the projected Medicare and Medicaid costs reported in the Fiscal Projections for the U.S. Government and Social Insurance information included in the unaudited Required Supplementary Information section of the *2012 Financial Report* and summarized in Management's Discussion and Analysis. The Required Supplementary Information section of the *2012 Financial Report* includes unaudited information concerning how changes in various assumptions would change the present value of future estimated expenditures in excess of future estimated revenue. As discussed in that section, Medicare projections are very sensitive to changes in the health care cost growth assumption.

In our opinion, the Statements of Social Insurance for 2009 and 2008 present fairly, in all material respects, the financial condition of the federal government's social insurance programs, in conformity with U.S. GAAP.

The Statement of Social Insurance presents the actuarial present value of the federal government's estimated future revenue to be received from or on behalf of participants and estimated future expenditures to be paid to or on behalf of participants, based on benefit formulas in current law and using a projection period sufficient to illustrate the long-term sustainability of the social insurance programs.<sup>18</sup> In preparing the Statements of Social Insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statement. However, because of the large number of factors that affect the Statement of Social Insurance and the fact that such assumptions are

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<sup>16</sup>The excess cost growth rate is the increase in health care spending per person relative to the growth of GDP per person after removing the effects of demographic changes on health care spending.

<sup>17</sup>In August 2010, the Secretary of Health and Human Services, working on behalf of the Board of Trustees, established an independent panel of expert actuaries and economists to review the assumptions and methods used by the Trustees to make projections of the financial status of the trust funds (commonly referred to as the 2010 Technical Review Panel on the Medicare Trustees Report). In December 2011, the panel members unanimously recommended a new approach that builds on certain long-standing assumptions while incorporating several key refinements. Based on the recommendations, the Medicare Trustees adopted new methods for projecting long-range Medicare costs in the 2012 Trustees Report. See section IV.D of the 2012 Medicare Trustees Report for details of the new methodology.

<sup>18</sup>The projection period used for the Social Security, Medicare, and Railroad Retirement social insurance programs is 75 years. For the Black Lung program, the projections are through September 30, 2040.

inherently subject to substantial uncertainty (arising from the likelihood of future events, significant uncertainties, and contingencies), there will be differences between the estimates in the Statement of Social Insurance and the actual results, and those differences may be material. In addition to the inherent uncertainty that underlies the expenditure projections prepared for all parts of Medicare, the Supplementary Medical Insurance Part D projections have an added uncertainty in that they were prepared using very little program experience upon which to base the estimates.

The scheduled future benefits presented in the Statement of Social Insurance are based on benefit formulas in current law. However, consistent with the respective annual Trustees Reports, the Social Security and Medicare programs are not projected to be sustainable under current financing arrangements. Also, the law concerning these programs can be changed at any time. Payment of Social Security and Medicare Hospital Insurance (Part A) benefits is limited by law to the balances in the respective trust funds. Consequently, future scheduled benefits are limited to future revenues plus existing trust fund assets. As discussed in the unaudited Required Supplementary Information section of the *2012 Financial Report*, the Social Security and Medicare Hospital Insurance (Part A) trust funds are, based on achievement of the cost reductions discussed above, projected to be exhausted in 2033 and 2024, respectively, at which time they will be unable to pay the full amount of scheduled future benefits. For Social Security, as of January 1, 2012, future revenues were projected to be sufficient to pay 75 percent of scheduled benefits in 2033, the year of projected trust fund exhaustion, and decreasing to 73 percent of scheduled benefits in 2086. Similarly, for Medicare Hospital Insurance (Part A), as of January 1, 2012, future revenues were projected to be sufficient to pay 87 percent of scheduled benefits in 2024, the year of projected trust fund exhaustion, and then decreasing to 69 percent of scheduled benefits in 2086.

### **Other Limitations on the Scope of Our Work**

For fiscal years 2012 and 2011, there were limitations on the scope of our work in addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements. Treasury and OMB depend on representations from certain federal entities to provide their representations to us regarding the U.S. government's consolidated financial statements. Treasury and OMB were unable to provide us with adequate representations regarding the U.S. government's accrual-based consolidated financial statements for fiscal years 2012 and 2011 primarily because of insufficient representations provided to them by certain federal entities.

### **Material Weaknesses Resulted in Ineffective Internal Control over Financial Reporting**

The material weaknesses discussed in this report resulted in ineffective internal control over financial reporting. Consequently, the federal government's internal control did not provide reasonable assurance that misstatements, losses, or noncompliance material in relation to the consolidated financial statements would be prevented or detected and corrected on a timely basis. The federal government is responsible for establishing and maintaining effective internal control over financial reporting and evaluating its effectiveness. Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial

statements in conformity with U.S. GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements.

In planning and performing our audit, we considered internal control over financial reporting. We did not consider all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We do not express an opinion on the effectiveness of internal control over financial reporting because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal control. Based on the scope of our work and the effects of the other limitations on the scope of our audit noted throughout this report, our internal control work would not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.<sup>19</sup> Further, our internal control work may not be sufficient for other purposes.

In addition to the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, which were discussed previously, we found the following four other material weaknesses in internal control. These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur and reasonably assure that appropriate actions are taken to reduce improper payments,
- identify and resolve information security control deficiencies and manage information security risks on an ongoing basis,
- effectively manage its tax collection activities, and
- effectively monitor and report loans receivable and loan guarantee liabilities.

These material weaknesses are discussed in more detail in appendix III, including the primary effects of the material weaknesses on the accompanying accrual-based consolidated financial statements and on the management of federal government operations.

We also found a significant deficiency in the federal government's internal control over management of federal grants related to deficiencies at certain federal entities. This significant deficiency is discussed in more detail in appendix IV.

Further, individual federal entity financial statement audit reports identified additional control deficiencies that were reported by the entities' auditors as either material weaknesses or significant deficiencies at the individual entity level. We do not consider these additional deficiencies to represent material weaknesses or significant deficiencies with respect to the consolidated financial statements.

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<sup>19</sup>A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

## Compliance with Laws and Regulations

Our work to test compliance with selected provisions of laws and regulations that have a direct and material effect on the consolidated financial statements was limited by the material weaknesses and other scope limitations discussed in this report. U.S. generally accepted government auditing standards and OMB guidance require auditors to report on entities' compliance with selected provisions of laws and regulations. Certain individual entity audit reports contain instances of noncompliance. None of these instances were deemed to be reportable noncompliance with regard to the accompanying consolidated financial statements.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with laws and regulations.

## Required Supplementary Information, Required Supplementary Stewardship Information, and Other Information

U.S. generally accepted accounting principles require that required supplementary information (RSI)<sup>20</sup> and required supplementary stewardship information (RSSI)<sup>21</sup> be presented in the *2012 Financial Report* to supplement the financial statements. This information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB), which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the RSI and RSSI in accordance with U.S. generally accepted government auditing standards because of the material weaknesses and other scope limitations discussed in this report. We did not audit and we do not express an opinion or provide any assurance on the RSI or RSSI.

Other information included in the *2012 Financial Report* contains a wide range of information, some of which is not directly related to the consolidated financial statements.<sup>22</sup> This information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements, RSI, or RSSI. An objective of our audit was to form an opinion on the consolidated financial statements. We did not audit and do not express an opinion or provide any assurance on the other information in the *2012 Financial Report*.

Readers are cautioned that the material weaknesses and scope limitations discussed in this audit report, including those related to our disclaimers of opinion on the 2012, 2011, and 2010 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, affect the reliability of certain information contained in the RSI, RSSI, and other information that is taken from the same data sources as the accrual-based consolidated financial statements; the 2012, 2011, and 2010 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts.

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<sup>20</sup>RSI is comprised of Management's Discussion and Analysis and information in the Required Supplementary Information section of the *2012 Financial Report*.

<sup>21</sup>RSSI is comprised of information on stewardship investments in the Required Supplementary Stewardship Information section of the *2012 Financial Report*.

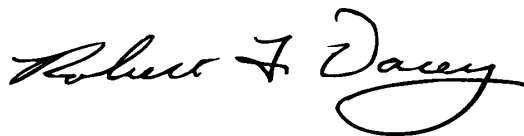
<sup>22</sup>Other information is comprised of information in the *2012 Financial Report* other than the consolidated financial statements, RSI, RSSI, the auditor's report, and the Statement of the Comptroller General of the United States.

## CFO Act Agency Financial Management Systems

The federal government's ability to efficiently and effectively manage and oversee its day-to-day operations and programs relies heavily on the ability of entity financial management systems to produce complete, reliable, timely, and consistent financial information for use by executive branch agencies and Congress.<sup>23</sup> FFMIA was designed to lead to system improvements that would result in CFO Act agency managers routinely having access to reliable, useful, and timely financial-related information to measure performance and increase accountability throughout the year. FFMIA requires auditors, as part of the 24 CFO Act agencies' financial statement audits, to report whether those agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's U.S. Standard General Ledger at the transaction level. For both fiscal years 2012 and 2011, auditors for 11 of the 24 CFO Act agencies reported that the agencies' financial management systems did not substantially comply with one or more of the three FFMIA requirements. Agency management at the 24 CFO Act agencies also annually report on FFMIA compliance. For fiscal years 2012 and 2011, agency management at 9 and 7 of the CFO Act agencies, respectively, reported that their agencies' financial management systems were not in substantial compliance with one or more of the three FFMIA requirements. Based on agency financial reports, the differences in the assessments of substantial compliance between the auditors and agency management reflected differences in views between management and the auditors on the impact reported deficiencies had on agencies' financial management systems. Long-standing financial management systems weaknesses at several large CFO Act agencies, along with the size and complexity of the federal government, continue to present a formidable management challenge in providing accountability to the nation's taxpayers and have contributed significantly to the material weaknesses and other limitations that have resulted in our disclaimers of opinion on the accrual-based consolidated financial statements.

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We provided a draft of this report to Treasury and OMB officials, who provided technical comments, which have been incorporated as appropriate. Treasury and OMB officials expressed their continuing commitment to address the problems this report outlines.



Robert F. Dacey  
Chief Accountant  
U.S. Government Accountability Office

January 9, 2013

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<sup>23</sup>FFMIA defines the term "financial management systems" to include the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

## Appendix I

### Objectives, Scope, and Methodology

Our objectives were to audit the consolidated financial statements for the fiscal years ended September 30, 2012 and 2011, including the Statements of Changes in Social Insurance Amounts for 2012 and 2011, and the 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance, along with reporting on internal control over financial reporting and on compliance with selected provisions of laws and regulations.

The Chief Financial Officers Act of 1990 (CFO Act), as expanded by the Government Management Reform Act of 1994 (GMRA), requires the inspectors general of the 24 CFO Act agencies to be responsible for annual audits of agencywide financial statements prepared by these agencies.<sup>24</sup> GMRA requires GAO to be responsible for the audit of the U.S. government's consolidated financial statements,<sup>25</sup> and the Accountability of Tax Dollars Act of 2002 (ATDA) requires most other executive branch entities to prepare and have audited annual financial statements.<sup>26</sup> The Office of Management and Budget and the Department of the Treasury (Treasury) have identified 35 federal entities that are significant to the U.S. government's consolidated financial statements, consisting of the 24 CFO Act agencies, several other federal executive branch agencies, and some government corporations (35 significant entities).<sup>27</sup> Our work was performed in coordination and cooperation with the inspectors general and independent public accountants for these 35 significant entities to achieve our respective audit objectives. Our audit approach regarding the accrual-based consolidated financial statements primarily focused on determining the current status of the material weaknesses that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements and the other material weaknesses affecting internal control that we had reported in our report on the consolidated financial statements for fiscal year 2011.<sup>28</sup> We also separately audited the financial statements of certain federal entities and federal agency components, including the following.

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2012 and 2011 financial statements.<sup>29</sup> In fiscal years 2012 and 2011, IRS collected about \$2.5 trillion and \$2.4 trillion, respectively, in tax payments and paid about \$373 billion and \$416 billion, respectively, in refunds to taxpayers. For fiscal year 2012, we continued to report a material weakness in internal control over unpaid tax assessments that resulted in ineffective internal control over financial reporting. In addition, we reported a significant deficiency in IRS's internal control over financial reporting systems. Due to the cumulative effects of corrective actions taken by IRS over the years and in fiscal year 2012, deficiencies related to financial reporting systems no longer collectively constitute a material weakness as we reported in each of our previous audits of IRS's financial statements.

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<sup>24</sup>31 U.S.C. 3521(e). GMRA authorized the Office of Management and Budget to designate agency components that also would receive a financial statement audit. See 31 U.S.C. 3515(c).

<sup>25</sup>GMRA, Pub. L. No. 103-356, § 405(c), 108 Stat. 3410, 3416-17 (Oct. 13, 1994), *codified at* 31 U.S.C. 331 (e)(2).

<sup>26</sup>ATDA, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002), *codified at* 31 U.S.C. 3515.

<sup>27</sup>See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 entities.

<sup>28</sup>For our report on the U.S. government's consolidated financial statements for fiscal year 2011, see Department of the Treasury, *2011 Financial Report of the United States Government* (Washington, D.C.: December 2011), 211-231, which can be found on GAO's website at [www.gao.gov/financial.html](http://www.gao.gov/financial.html).

<sup>29</sup>GAO, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-120 (Washington, D.C.: Nov. 9, 2012).



However, these deficiencies, which include both recurring and newly identified issues, are collectively important enough to merit the attention of those charged with governance. We also reported that we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested. Further, we found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996.

- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2012 and 2011.<sup>30</sup> For these 2 fiscal years, the schedules reported (1) approximately \$11.3 trillion (2012) and \$10.1 trillion (2011) of federal debt held by the public;<sup>31</sup> (2) about \$4.8 trillion (2012) and \$4.7 trillion (2011) of intragovernmental debt holdings;<sup>32</sup> and (3) about \$245 billion (2012) and \$251 billion (2011) of interest on federal debt held by the public. We reported that as of September 30, 2012, BPD had effective internal control over financial reporting relevant to the Schedule of Federal Debt. Further, we reported that we found no reportable noncompliance in fiscal year 2012 with selected provisions of laws related to the Schedules of Federal Debt we tested.
- We audited and expressed unqualified opinions on the fiscal years 2012 and 2011 financial statements of the U.S. Securities and Exchange Commission (SEC) and its Investor Protection Fund (IPF).<sup>33</sup> We also reported that as of September 30, 2012, although SEC's internal controls could be improved, SEC had effective internal control over financial reporting for both the entity as a whole and the IPF. In addition, we reported that we found no reportable noncompliance for either SEC or IPF in fiscal year 2012 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the fiscal years 2012 and 2011 financial statements of the Federal Housing Finance Agency (FHFA).<sup>34</sup> We reported that FHFA had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested.
- We audited and expressed an unqualified opinion on the Office of Financial Stability's (OFS) fiscal years 2012 and 2011 financial statements for the Troubled Asset Relief Program (TARP).<sup>35</sup> We reported that OFS had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance in fiscal year 2012 with the selected provisions of laws and regulations we tested.

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<sup>30</sup>GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2012 and 2011 Schedules of Federal Debt*, GAO-13-114 (Washington, D.C.: Nov. 8, 2012).

<sup>31</sup>The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, foreign governments, and central banks.

<sup>32</sup>Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.

<sup>33</sup>GAO, *Financial Audit: Securities and Exchange Commission Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-122R (Washington, D.C.: Nov. 15, 2012).

<sup>34</sup>GAO, *Financial Audit: Federal Housing Finance Agency's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-124R (Washington, D.C.: Nov. 15, 2012).

<sup>35</sup>GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-126R (Washington, D.C.: Nov. 9, 2012).

- We audited and expressed an unqualified opinion on the fiscal years 2012 and 2011 financial statements of the Bureau of Consumer Financial Protection (CFPB).<sup>36</sup> We reported that CFPB had effective internal control over financial reporting as of September 30, 2012, and we found no reportable noncompliance for fiscal year 2012 with the selected provisions of laws and regulations we tested.

In addition, we considered the CFO Act agencies' and certain other federal entities' fiscal years 2012 and 2011 financial statements and the related auditors' reports prepared by the inspectors general or contracted independent public accountants. Financial statements and audit reports for the 35 significant entities provide information about the operations of each of these entities. The entity audit reports also contain details regarding any audit findings and related recommendations for the respective entity. We did not audit, and we do not express an opinion on, any of these individual federal entity financial statements.

We considered the Department of Defense's (DOD) assertion in the *DOD Agency Financial Report for Fiscal Year 2012* regarding its noncompliant financial systems and lack of reasonable assurance that internal controls over financial reporting were effective. In addition, in the DOD Inspector General's fiscal year 2012 report on internal control over financial reporting, the Inspector General cited material weaknesses in several areas, including (1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations; and (5) material amounts of unsupported accounting entries needed to prepare DOD's annual consolidated financial statements.

Because of the significance of the amounts presented in the Statements of Social Insurance and Statements of Changes in Social Insurance Amounts related to the Social Security Administration (SSA) and the Department of Health and Human Services (HHS), our audit approach regarding these statements focused primarily on these two agencies. For each federal entity preparing a Statement of Social Insurance and Statement of Changes in Social Insurance Amounts,<sup>37</sup> we considered the entity's 2012, 2011, 2010, 2009, and 2008 Statements of Social Insurance and the 2012 and 2011 Statements of Changes in Social Insurance Amounts, as well as the related auditor's reports prepared by the inspectors general or contracted independent public accountants. We believe our audit, including internal control and substantive audit procedures, reperformance procedures, and review of the other auditors' Statement of Social Insurance-related audit work, provides a reasonable basis for our opinions on the 2009 and 2008 Statements of Social Insurance.

We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and compliance with selected provisions of laws and regulations. We considered the limitations on the scope of our work regarding the accrual-based consolidated financial statements; the 2012, 2011, and 2010 Statements of Social Insurance; and the 2012 and 2011 Statements of Changes in Social Insurance Amounts in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

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<sup>36</sup>GAO, *Financial Audit: Bureau of Consumer Financial Protection's Fiscal Years 2012 and 2011 Financial Statements*, GAO-13-125R (Washington, D.C.: Nov. 15, 2012).

<sup>37</sup>These entities are SSA, HHS, the Railroad Retirement Board, and the Department of Labor.

## Appendix II

### **Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual-Based Consolidated Financial Statements**

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual-based consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the accompanying accrual-based consolidated financial statements, as described below.

#### Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the accrual-based consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Certain other entities reported continued deficiencies in internal control procedures and processes related to PP&E.

Deficiencies in internal control over such assets could affect the federal government's ability to fully know the assets it owns, including their location and condition, and its ability to effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets and reliably report asset balances; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

#### Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including any related to treaties and other international agreements entered into to further the federal government's interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, deficiencies in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as adversely affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, to the extent disclosures of

commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

#### Cost of Government Operations and Disbursement Activity

Reported net costs were affected by the previously discussed material weaknesses in reporting assets and liabilities; material weaknesses in financial statement preparation, as discussed below; and the lack of adequate disbursement reconciliations at certain federal entities. As a result, the federal government was unable to support significant portions of the reported total net cost of operations, most notably those related to DOD.

With respect to disbursements, DOD and certain other federal entities reported continued material weaknesses and significant deficiencies in reconciling disbursement activity. For fiscal years 2012 and 2011, unreconciled disbursement activity, including unreconciled differences between federal entities' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal entity adjustments, totaled billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required or authorized. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal entities for inclusion in *The Budget of the United States Government* (President's Budget) concerning obligations and outlays.

#### Accounting for and Reconciliation of Intragovernmental Activity and Balances

Although progress has been made, federal entities continue to be unable to adequately account for and reconcile intragovernmental activity and balances. The federal government's progress varies by category.<sup>38</sup> The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 significant entities to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these entities are required to report to Treasury, their respective inspectors general, and GAO on the extent and results of intragovernmental activity and balance-reconciliation efforts as of the end of the fiscal year.

As in prior years, a substantial number of the entities did not adequately perform the required year-end reconciliations for fiscal year 2012. Based on trading partner information provided to Treasury in the 35 significant entities' closing packages, Treasury provided a *Material Differences Report* to each entity showing amounts for certain intragovernmental activity and balances that significantly differed from those of the entity's corresponding trading partners as of the end of the fiscal year. Entities are required to complete their *Material Differences Reports*, including providing explanations of the reasons for certain differences. Based on our review of completed *Material Differences Reports* for fiscal year 2012, we continue to note that amounts reported by federal entity trading partners for certain intragovernmental accounts were not in agreement by significant amounts. We noted that several CFOs cited differing accounting methodologies, accounting errors, and timing differences for unreconciled amounts reported in

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<sup>38</sup>Treasury has grouped intragovernmental activities and balances into five broad categories.

their *Material Differences Reports*. Some CFOs indicated that they did not know the reason for the differences. In addition, some CFOs confirmed the balance or activity, but differences continued to exist.

Further, there continue to be hundreds of billions of dollars of unreconciled differences between the General Fund of the U.S. Government and federal entity trading partners related to appropriations and other intragovernmental transactions. The ability to reconcile such transactions is hampered because only some of the General Fund of the U.S. Government is reported in Treasury's department-level financial statements. As a result of these circumstances, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual-based consolidated financial statements is significantly impaired.

During fiscal year 2012, Treasury expanded its ongoing efforts to help resolve and eliminate material differences in intragovernmental activity and balances. These efforts included developing and implementing a formalized resolution plan and related corrective actions intended to address long-standing intragovernmental challenges. As part of its plan, Treasury monitors entities' reconciliation efforts and compliance with *Treasury Financial Manual* guidance. For example, Treasury began a pilot program with 14 entities that included providing them with quarterly metrics/scorecards highlighting differences requiring attention. In fiscal year 2013, Treasury plans to expand the distribution of the quarterly metrics/scorecards to include all 35 significant entities. Further, Treasury is in the process of establishing separate reporting for the General Fund, which includes intragovernmental transactions. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong and sustained commitment by federal entities to timely resolve differences with their trading partners, as well as continued strong leadership by OMB and Treasury.

#### Preparation of Consolidated Financial Statements

While Treasury, in coordination with OMB, implemented corrective actions during fiscal year 2012 to address certain internal control deficiencies detailed in our previously issued report, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited entity financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (U.S. GAAP). During our fiscal year 2012 audit, we found the following.<sup>39</sup>

- Treasury's process for compiling the consolidated financial statements generally demonstrated that amounts in the Statement of Social Insurance and the Statement of Changes in Social Insurance Amounts were consistent with the underlying federal entities' financial statements and that the Balance Sheet and the Statement of Net Cost were also consistent with the 35 significant federal entities' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process did not ensure that the information in the remaining three principal financial statements (Statement of Operations and Changes in Net Position, Reconciliation of Net Operating Cost and Unified

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<sup>39</sup>Most of the issues we identified in fiscal year 2012 existed in fiscal year 2011, and many have existed for a number of years. Most recently, in June 2012, we reported the issues we identified to Treasury and OMB and provided recommendations for corrective action. See GAO, *Management Report: Improvements Needed in Controls over the Preparation of the U.S. Consolidated Financial Statements*, GAO-12-529 (Washington, D.C.: June 27, 2012).

Budget Deficit, and Statement of Changes in Cash Balance from Unified Budget and Other Activities) was fully consistent with the underlying information in the 35 significant federal entities' audited financial statements and other financial data.

- For fiscal year 2012, auditors reported internal control deficiencies at several entities regarding entities' financial reporting processes that could affect information included in the respective entities' closing packages.<sup>40</sup> Further, Treasury had to record significant adjustments to correct errors found in federal entities' audited closing package information. To ensure consistency of underlying entity information and financial data with the U.S. government's consolidated financial statements, entity auditors are required to separately audit and report on the financial information that the 35 significant federal entities send to Treasury through closing packages.
- Treasury is unable to properly balance the accrual-based consolidated financial statements. To make the fiscal years 2012 and 2011 consolidated financial statements balance, Treasury recorded net increases of \$20.2 billion and \$15.6 billion, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which were identified as "Unmatched transactions and balances."<sup>41</sup> Treasury recorded an additional net \$1.8 billion and \$6.0 billion of unmatched transactions in the Statement of Net Cost for fiscal years 2012 and 2011, respectively. The material weakness in federal entities' ability to account for and reconcile intragovernmental activity and balances, discussed above, significantly contributes to the unmatched transactions and balances and consequently impairs Treasury's ability to fully eliminate such intragovernmental activity and balances.
- The federal government has not established and implemented effective processes and procedures for identifying and reporting all items needed to (1) prepare the Statement of Changes in Cash Balance from Unified Budget and Other Activities and (2) reconcile the operating results to the budget results. Typical reconciling items would include both accrual-based costs that are not yet recognized in the unified budget deficit and budget costs that are not yet recognized in the net operating cost.
- Over the past several years, significant actions have been taken to assist in ensuring that financial information is reported or disclosed in the consolidated financial statements in conformity with U.S. GAAP. However, Treasury's reporting of certain financial information required by U.S. GAAP continues to be impaired. Due to certain control deficiencies noted in this report—for example, commitments and contingencies related to treaties and other international agreements—Treasury is precluded from determining if additional disclosure is required by U.S. GAAP in the consolidated financial statements, and we are precluded from determining whether the omitted information is material. Further, Treasury's ability to report information in conformity with U.S. GAAP will also remain impaired until federal entities, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

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<sup>40</sup>The closing package methodology links federal entities' audited consolidated department-level financial statements to certain of the U.S. government's consolidated financial statements.

<sup>41</sup>Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relates to net operating cost, it reported this amount as a component of net operating cost in the accompanying consolidated financial statements.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal entities within those branches have provided Treasury such information. However, as we have reported in past years, undetermined amounts of assets, liabilities, costs, and revenues are not included, and the federal government did not provide evidence that the excluded financial information was immaterial.
- Other internal control deficiencies existed in the process for preparing the consolidated financial statements, involving (1) inadequate design and ineffective implementation of policies and procedures related to certain areas, such as analysis of federal entity-provided data, journal vouchers, and calendar year-end entities and (2) inadequate processes for monitoring and assessing internal controls over the preparation of the consolidated financial statements. As a result, we identified errors in draft consolidated financial statements that were subsequently corrected.
- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2012 financial reporting challenges it faced, such as control deficiencies in its process for preparing the consolidated financial statements noted above. We found that there were not enough personnel in Treasury's Financial Management Service with specialized financial reporting experience to help ensure reliable financial reporting. In addition, the federal government does not perform interim compilations at the government-wide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year. Treasury has taken various steps to begin to address these issues, including (1) obtaining and utilizing certain interim financial information from federal entities in preparing initial financial statement drafts, (2) supplementing staff during the financial report preparation process, and (3) considering opportunities resulting from the ongoing consolidation of operations of Treasury's Financial Management Service and Bureau of the Public Debt.

Until these internal control deficiencies have been fully addressed, the federal government's ability to ensure that the consolidated financial statements are consistent with the underlying audited federal entities' financial statements, properly balanced, and in conformity with U.S. GAAP will be impaired. Resolving these internal control deficiencies remains a difficult challenge and will require a strong and sustained commitment from Treasury and OMB as they continue to execute and implement their corrective action plans.

#### Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and the Statement of Changes in Cash Balance from Unified Budget and Other Activities report a unified budget deficit for fiscal years 2012 and 2011 of about \$1.1 trillion and \$1.3 trillion, respectively.<sup>42</sup> The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts). Also, the Fiscal Projections for the U.S. Government included in the

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<sup>42</sup>The budget deficit, receipts, and outlays amounts are reported in Treasury's *Monthly Treasury Statement* and the President's Budget.

unaudited Required Supplementary Information section of the *2012 Financial Report* use such outlays and receipts.

For several years, we have been reporting significant unreconciled differences between the total net outlays reported in selected federal entities' Statements of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit reported in the consolidated financial statements. Unreconciled net outlays of about \$55 billion and \$31 billion existed for fiscal years 2012 and 2011, respectively. OMB and Treasury have recognized that it will take a coordinated effort to establish effective processes and procedures for identifying, resolving, and explaining material differences in this and other components of the deficit between Treasury's central accounting records and information reported in entity financial statements and underlying entity financial information and records. Until these types of differences are reconciled in a timely manner by the federal government, their effect on the U.S. government's consolidated financial statements will continue to be unknown. In fiscal year 2012, Treasury began to develop a methodology for reconciling operating revenue to budget receipts on a government-wide basis. In addition, an external organization performed a broad review of the government-wide financial report preparation process and provided several recommendations for improvements, including some related to reconciling components of the budget deficit. Treasury stated that it will consider these recommendations in developing its methodology.

In fiscal year 2012, we again noted that several entities' auditors reported internal control deficiencies (1) affecting the entities' SBRs and (2) related to monitoring, accounting, and reporting of budgetary transactions. These control deficiencies could affect the reporting and calculation of the net outlay amounts in the entities' SBRs. In addition, such deficiencies may also affect the entities' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget deficit reported in the accrual-based consolidated financial statements. The unified budget deficit is also reported by Treasury in its *Combined Statement of Receipts, Outlays, and Balances*,<sup>43</sup> and in other federal government publications.

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<sup>43</sup>Treasury's *Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash-related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on entity reporting.



## Appendix III

### Other Material Weaknesses

Material weaknesses in internal control discussed in this report resulted in ineffective controls over financial reporting. In addition to the material weaknesses discussed in appendix II that contributed to our disclaimer of opinion on the accrual-based consolidated financial statements, we found the following four other material weaknesses in internal control.

#### Improper Payments

Reducing improper payments is critical to safeguarding federal funds.<sup>44</sup> During fiscal year 2012, the federal government continued to make progress in identifying and reporting on improper payments. Entities reported improper payment estimates for nine additional programs when compared to fiscal year 2011.<sup>45</sup> Most notably, the Department of Health and Human Services (HHS) reported an estimated improper payment amount for the Children's Health Insurance Program of \$704 million. Nevertheless, the federal government continues to face challenges in determining the full extent of improper payments. For example, four federal entities did not report fiscal year 2012 estimated improper payment amounts for 10 risk-susceptible programs, including HHS's Temporary Assistance for Needy Families. The Improper Payments Information Act of 2002 (IPIA), as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA),<sup>46</sup> requires federal executive branch entities to (1) review all programs and activities, (2) identify those that may be susceptible to significant improper payments, (3) estimate the annual amount of improper payments for those programs and activities, (4) implement actions to reduce improper payments and set reduction targets, and (5) report on the results of addressing the foregoing requirements. IPERA also established a requirement for entity inspectors general to report annually on entities' compliance, as defined in IPERA. In March 2012, the inspectors general began issuing their reports under this requirement covering fiscal year 2011. The reports identified issues such as improper risk assessment methods used by entities to identify programs and activities susceptible to significant improper payments, estimates not being reported for susceptible programs, and improper payment reduction targets not being set.

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<sup>44</sup>Under the Improper Payments Information Act of 2002, as amended, improper payments are statutorily defined as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible good or service, any duplicate payment, any payment for a good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts.

<sup>45</sup>Of the nine programs, the Office of Management and Budget (OMB) excluded four programs from its government-wide totals because those programs did not have OMB-approved sampling methodologies for estimating improper payments.

<sup>46</sup>IPIA, Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002), as amended by IPERA, Pub. L. No. 111-204, 124 Stat. 2224 (July 22, 2010), and reprinted in 31 U.S.C. 3321 note. As of the date of this report, H.R. 4053, the Improper Payments Elimination and Recovery Improvement Act of 2012, was awaiting the President's signature. The Act would require federal entities to take additional steps to identify and prevent improper payments. The Act would enact into law elements of the President's "Do Not Pay List" initiative by requiring entities to review prepayment and pre-award procedures and ensure a thorough review of available databases to determine program or award eligibility before the release of any federal funds. The Act would also direct OMB to annually identify a list of high-priority federal programs for greater levels of oversight and review and would require each entity responsible for one of these high-priority programs to annually submit a program report to its inspector general and make a report copy available to the public.

The Office of Management and Budget (OMB) reported total federal entity improper payment estimates of \$107.7 billion in fiscal year 2012. This is a decrease from the prior year revised estimate of \$115.7 billion as reported by federal entities.<sup>47</sup> These estimates represented about 4.4 percent and 4.7 percent of reported outlays for the associated programs in fiscal years 2012 and 2011, respectively. Decreases in reported estimates of improper payments were mostly attributable to four major programs: the decreases for the Department of Labor's Unemployment Insurance and the Department of the Treasury's Earned Income Tax Credit programs were attributable to decreases in reported outlays, and the decreases for HHS's Medicaid and the Social Security Administration's Old-Age, Survivors, and Disability Insurance programs were attributable to decreases in reported error rates.<sup>48</sup> It is important to note that, pursuant to OMB implementing guidance, reported improper payment estimates include overpayments, underpayments, and payments for which adequate documentation was not found, and may also include amounts of payments for years prior to the current fiscal year.

In addition to the issues reported by entity inspectors general as noted above, entity auditors continued to report internal control deficiencies over financial reporting, such as financial system limitations and information system control weaknesses, which significantly increase the risk that improper payments may occur and not be detected promptly.

Until the federal government has implemented effective processes to determine the full extent to which improper payments occur and appropriate actions are taken across entities and programs to effectively reduce improper payments, the federal government will not have reasonable assurance that the use of federal funds is adequately safeguarded.

### Information Security

Although progress has been made, serious and widespread information security control deficiencies reported during fiscal year 2012 continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Specifically, control deficiencies were identified related to (1) security management; (2) access to computer resources (data, equipment, and facilities); (3) changes to information system resources; (4) segregation of incompatible duties; and (5) contingency planning. We have reported information security as a high-risk area across government since February 1997.

Such information security control deficiencies unnecessarily increase the risk that data recorded in or transmitted by federal financial management systems are not reliable and available. A primary reason for these deficiencies is that federal entities generally have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control deficiencies, resolving information security problems, and managing information security risks on an ongoing basis. The federal government has taken important actions to improve information security, such as enhancing performance measures and

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<sup>47</sup>In their fiscal year 2012 Performance and Accountability Reports (PAR) and Annual Financial Reports (AFR), three federal entities updated their fiscal year 2011 improper payment estimates to reflect changes since issuance of their fiscal year 2011 PARs and AFRs. These updates increased the government-wide improper payment estimate for fiscal year 2011 from \$115.3 billion to \$115.7 billion.

<sup>48</sup>Reported error rates reflect the estimated improper payments as a percentage of total program outlays.

reporting processes necessary for monitoring and assessing the effectiveness of agencies' information security programs. In addition, the administration established goals to achieve, by the end of fiscal year 2014, 95 percent use of (1) trusted Internet connections to consolidate external telecommunication access points; (2) continuous monitoring of federal information systems; and (3) strong authentication through the increased use of federal smart card credentials, such as Personal Identity Verification and Common Access Cards. Until entities identify and resolve information security control deficiencies and manage information security risks on an ongoing basis, federal data and systems, including financial information, will remain at risk.

### Tax Collection Activities

During fiscal year 2012, a material weakness continued to affect the federal government's ability to effectively manage its tax collection activities. Due to financial system limitations, as well as errors and delays in recording taxpayer information, the federal government's records did not always reflect the correct amount of taxes owed by the public to the federal government. Such errors and delays may cause undue burden and frustration to taxpayers who either have already paid taxes owed or who owe significantly lower amounts. Collectively, these deficiencies indicate that internal controls were not effective in (1) ensuring that reported amounts of taxes receivable and other tax assessments were accurate on an ongoing basis and could be relied upon by management as a tool to aid in making and supporting resource allocation decisions and (2) supporting timely and reliable financial statements, accompanying notes, and required supplementary information and other information without extensive supplemental procedures and adjustments.

### Loans Receivable and Loan Guarantee Liabilities

Internal control deficiencies were identified at certain federal entities that accounted for the majority of the reported balances for loans receivable and loan guarantee liabilities. The deficiencies related to monitoring and reporting loan and loan-related activity, and to credit subsidy estimation and related financial reporting processes. In fiscal year 2012, the Department of Education, which accounted for the largest reported balance of loans receivable, experienced internal control deficiencies related to the implementation of new debt management collection and direct loan servicing systems. The department's deficiencies affected, among other things, its ability to process certain types of transactions, prepare certain system reconciliations in a timely manner, and properly report interest accruals.

Such deficiencies and issues, and complexities associated with estimating the costs of lending and other loan-related financing activities, significantly increase the risk that misstatements in entity and government-wide financial statements could occur and go undetected. Further, control deficiencies related to estimating the costs of lending and other loan-related financing activities can adversely affect the federal government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.

## Appendix IV

### **Significant Deficiency**

In addition to the material weaknesses discussed in appendixes II and III, we found a significant deficiency in the federal government's internal control over management of federal grants, related to deficiencies at certain federal entities. Also, we reported a significant deficiency in fiscal year 2011 regarding loans receivable and loan guarantee liabilities. We considered the control deficiencies in loans receivable and loan guarantee liabilities to be a material weakness in fiscal year 2012, as noted above, as additional control deficiencies in this area were identified in fiscal year 2012.

### Federal Grants Management

In fiscal year 2012, federal grants management internal control deficiencies, primarily regarding inadequate monitoring and oversight of grant programs, were identified at several federal entities. For example, the auditor of one federal entity that awards and manages significant amounts of grants reported that related information and communication systems did not collect and disseminate timely, reliable, and relevant information to those charged with making informed decisions regarding grants. Additionally, another entity's auditor reported that effective monitoring procedures over certain grant activities and the maintenance of related documentation have not been implemented. These internal control deficiencies could adversely affect the federal government's ability to ensure that grant funds are being used in accordance with applicable program laws and regulations.