United States Government Notes to the Financial Statements for the Fiscal Years Ended September 30, 2017, and 2016

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, and the judicial branch of the government. The financial reporting period ends September 30 and is the same as used for the annual budget. The legislative and judicial branches are not required by law to submit financial statement information to Treasury; however, these branches are included in the *Financial Report*. Appendix A of this report lists the organizations and agencies (entities) included in the U.S. Government's consolidated reporting entity for the *Financial Report,* as well as some entities not included in the reporting entity. Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Concepts (SFFAC) 2, *Entity and Display*, provides criteria for determining which entities are included in the reporting entity. Such criteria are summarized in Appendix A. Also, as discussed further in Appendix A, certain entities are excluded from the *Financial Report* because they do not meet the criteria, such as Federal Home Loan Banks, or were specifically excluded from the consolidated reporting entity in accordance with SFFAC 2, such as the Board of Governors of the Federal Reserve System and bailout entities. Examples of bailout entities include the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae).

During fiscal year 2008, the government began a number of emergency economic measures relating to the economy that involved various financing programs. Key initiatives beginning in fiscal year 2008 involved programs concerning Fannie Mae and Freddie Mac (Government-Sponsored Enterprises [GSEs]), provision of a credit facility for GSEs and Federal Home Loan Banks, purchase of Mortgage-Backed Securities (MBSs), see Note 1.H—Investments in Government-Sponsored Enterprises and Note 8—Investments in Government-Sponsored Enterprises for detailed information.

Following GAAP for federal entities, the government has not consolidated into its financial statements the assets, liabilities, or results of operations of any financial organization or commercial entity in which Treasury holds either a direct, indirect, or beneficial equity investment. Even though some of the equity investments are significant, under SFFAC 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.

Intragovernmental transactions are eliminated in consolidation, except as described in the Other Information—Unmatched Transactions and Balances, see Note 1.S—Unmatched Transactions and Balances for detailed information.

B. Basis of Accounting and Revenue Recognition

Consolidated Financial Statements

The consolidated financial statements of the government were prepared using GAAP, primarily based on FASAB's Statement of Federal Financial Accounting Standards (SFFAS). The consolidated financial statements include accrual-based financial statements and sustainability financial statements, which are discussed in more detail below, and the related notes to the consolidated financial statements. Collectively, the accrual-based financial statements, the sustainability financial statements, and the notes represent basic information that is deemed essential for the financial statements and notes to be presented in conformity with GAAP.

Accrual-Based Financial Statements

The accrual-based financial statements were prepared under the following principles:

- Expenses are generally recognized when incurred.
- Non-exchange revenue, including taxes, duties, fines, and penalties, are recognized when collected and adjusted for the change in net measurable and legally collectible amounts receivable. Related refunds and other offsets, including those that are measurable and legally payable, are netted against non-exchange revenue.
- Exchange (earned) revenue is recognized when the government provides goods and services to the public for a price. Exchange revenue includes 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 basis (budget deficit) 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 Budget Deficit in the Financial Statements section.

Sustainability Financial Statements

The sustainability financial statements were prepared based on the projected present value of the estimated future revenue and estimated future expenditures, primarily on a cash basis, for a 75 year period[1]. They include the Statements of Long-Term Fiscal Projections, covering all federal government programs, and the Statements of Social Insurance and the Statements of Changes in Social Insurance Amounts, covering social insurance programs (Social Security, Medicare, Railroad Retirement, and Black Lung programs). These estimates are based on economic as well as demographic assumptions presented in Notes 22 and 23. The sustainability financial statements are not forecasts or predictions. The sustainability financial statements are designed to illustrate the relationship between receipts and expenditures, if current policy is continued. For this purpose, the projections assume that scheduled social insurance benefit payments would continue after related trust funds are projected to be exhausted, contrary to current law, and that debt could continue to rise indefinitely without severe economic consequences.

By accounting convention, the Statements of Social Insurance do not include projected general revenues that, under current law, would be used to finance the remainder of the expenditures in excess of revenues for Medicare Parts B and D that is reported in the Statements of Social Insurance. The Statements of Long-Term Fiscal Projections include all revenues (including general revenues) of the federal government.

New Standards Issued in Prior Years and Implemented in Current Year

Beginning in fiscal year 2016, the government implemented the requirements of new standards related to the reporting for: Inventories and Related Property and Property, Plant, and Equipment. The standards being implemented are:

- FASAB issued SFFAS No. 48, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials.* SFFAS No. 48 permits a reporting entity to apply an alternative valuation method in establishing opening balances and applies when a reporting entity is presenting financial statements or one or more line items addressed by this statement. This method is permitted when presenting financial statements or one or more line items addressed in the standard. This standard can be applied for the first time or after a period during which existing systems could not provide the information necessary for producing GAAP-based financial statements without use of the alternative valuation methods. This is intended to provide an alternative method to adoption of GAAP when historical records and systems do not provide a basis for valuation of opening balances in accordance with SFFAS No. 3, *Accounting for Inventory and Related Property.* Reporting entities that meet either condition and elect to apply this statement should follow the guidance in SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles.* SFFAS No. 48 is effective beginning in fiscal year 2017. Early implementation was permitted. DOD did partially implement in 2016 and select component entities have continued to implement in 2017. DOD has not declared full implementation yet.
- FASAB issued SFFAS No. 50, *Establishing Opening Balances for General Property, Plant and Equipment.* SFFAS No. 50 permits a reporting entity to apply an alternative valuation method in establishing opening balances and applies when a reporting entity is presenting financial statements or one or more line items addressed by this statement. This standard can be applied for the first time or after a period during which existing systems could not provide the information necessary for producing GAAP-based financial statements without use of the alternative valuation methods. This is intended to provide an alternative method to adoption of GAAP when historical records and systems do not provide a basis for valuation of opening balance in accordance with SFFAS No. 6, *Accounting for Property, Plant, and Equipment*. This application is available to each reporting entity only once per line item

[1] With the exception of the Black Lung program, which has a rolling 25-year projection period through September 30, 2042.

addressed in this statement. Reporting entities meeting the conditions and electing to apply this statement should follow the guidance in SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles.* SFFAS No. 50 is effective beginning in fiscal year 2017. Early implementation was permitted. DOD did partially implement in 2016 and select component entities have continued to implement in 2017. DOD has not declared full implementation yet.

New Standards Issued and Not Yet Implemented

FASAB issued the following new standards that are applicable to the *Financial Report*, but are not yet implemented at the governmentwide level for fiscal year 2017:

- In December 2014, FASAB issued SFFAS No. 47, *Reporting Entity*. SFFAS No. 47 establishes principles to identify organizations for which elected officials are accountable. The standard also guides preparers of general purpose federal financial reports in determining what organizations to report upon, whether such organizations are considered "consolidation entities" or "disclosure entities," and what information should be presented about those organizations. An organization is considered a consolidation entity if, based on assessment of the following characteristics as a whole, the organization: is financed through taxes and other non-exchange revenues, is governed by the Congress and/or President, imposes or may impose risks and rewards to the federal government, and provides goods and services on a non-market basis. Organizations listed in the budget, except for non-federal organizations receiving federal assistance, would generally qualify as consolidation entities (Consolidation aggregates the individual financial statements of organizations that constitute a reporting entity and results in presentation of information for a single economic entity representing consolidated activities supported by taxes and other non-exchange revenue, resources, and obligations). A disclosure entity has a greater degree of autonomy with the federal government than a consolidation entity. To avoid obscuring information about these more autonomous organizations while still providing accountability, certain information for each disclosure entity (such as the nature of the federal government's relationship to the disclosure entity, magnitude of relevant activity, and future exposure) and the aggregation of the disclosure entities are only going to be disclosed at the governmentwide level. The standard also requires information to be provided about related party relationships (organizations are considered related parties if one party has the ability to exercise significant influence over the other party in making policy decisions). SFFAS No. 47 is effective for periods beginning after September 30, 2017 and early implementation is not permitted.
- In April 2016, FASAB issued SFFAS No. 49, *Public-Private Partnerships Disclosure Requirements.* SFFAS No. 49 establishes principles to ensure disclosure about Public-Private Partnerships (P3s) are presented in the reporting entity's general purpose federal financial reports (GPFFRs). P3s are defined as "risk sharing" arrangements or transactions lasting more than five years between public and private sector entities. Disclosure requirements comprise quantitative and qualitative information to assist users in understanding the nature of P3s. P3s disclosures help achieve the operating performance and budgetary integrity objectives outlined in SFFAC No. 1. P3s are a form of investments. They should be adequately disclosed in order to assist report users in determining: (a) the important assets of the U.S. government and how effectively they are being managed and (b) the identification of risks. SFFAS No. 49 is effective for periods beginning after September 30, 2018 and early implementation is permitted; however, it is not being early implemented in fiscal year 2017.
- In January 2017, FASAB issued SFFAS No. 51, *Insurance Programs*. SFFAS No. 51 establishes accounting and financial reporting standards to ensure that insurance programs are adequately defined and report consistent information about the liabilities for losses incurred and claimed as well as expected losses during remaining coverage. These will replace the insurance guarantee program standards provided in paragraphs 97-121 of SFFAS No. 5, *Accounting for Liabilities of the Federal Government.* To support consistency, it identifies three categories: 1) exchange transaction insurance programs other than life insurance, 2) nonexchange transaction insurance programs and 3) life insurance programs. Insurance programs are categorized based upon the type of revenue received as defined by SFFAS No. 7, *Accounting for Revenue and Other Financing and Concepts for Reconciling Budgetary and Financial Accounting*, as amended. This provides guidance as to how and when insurance programs should recognize revenue, expenses and liabilities according to the aforementioned categories. The recognition measurement, and disclosure guidance provides for concise, meaningful and transparent information regarding the operating performance of insurance programs. SFFAS No. 51 is effective for periods beginning after September 30, 2018 and early implementation is not permitted.
- In May 2017, FASAB issued SFFAS 52, *Tax Expenditures*. SFFAS No. 52 requires certain information on tax expenditures to assist users of the *Financial Report* in understanding the existence, purpose, and impact of tax expenditures. It requires that the *Financial Report* include narrative disclosures and information regarding tax expenditures, the general purpose of tax expenditures, the impact on and treatment of tax expenditures within the federal budget process, and the impact of tax expenditures on the government's financial position and condition. It

also requires that the *Financial Report* alert readers regarding the availability of published information on tax expenditure estimates, such as those published annually by the Department of the Treasury's Office of Tax Policy. SFFAS No. 52 also encourages presentation of tax expenditures as other information (OI) in the *Financial Report*. SFFAS No. 52 is effective for periods beginning after September 30, 2017 and early implementation is permitted; however, it is not being early implemented.

C. 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 amounts. 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 or a court has determined the assessments are owed. Taxes receivable do not include unpaid assessments when taxpayers or a court have not 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 (write-offs). Taxes receivable are reported net of an allowance for the estimated portion deemed to be uncollectible. The majority of the allowance for uncollectible amounts is based on projections of collectible amounts from a statistical sample of unpaid assessments.

D. Loans Receivable and Loan Guarantee Liabilities

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 cash flows 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 cash flows for those loans or guarantees. A subsidy expense also is recognized for modifications made during the year to loans and guarantees outstanding and for re-estimates 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 cash flows. The liability for loan guarantees is the present value of expected net cash outflows due to the loan guarantees.

E. 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 a method that reasonably approximates historical cost. Historical cost methods include first-in-first-out, weighted average, and moving average. Any other valuation method may be used if the results reasonably approximate one of the historical cost methods. FASAB issued additional guidance SFFAS No. 48, which permits a reporting entity to apply an alternative valuation method in establishing opening balances for inventory, operating materials and supplies and stockpile materials and is intended to provide an alternative valuation method when historical records and systems do not provide a basis for valuation of opening balances in accordance with SFFAS No. 3.

DOD values approximately 98 percent of resale inventory using the moving average cost method. Additionally, DOD reports the remaining 2 percent of resale inventories at an approximation of historical cost using latest acquisition cost (LAC) adjusted for holding gains and losses. DOD continues to implement SFFAS No. 48. Some components within DOD used the deemed cost measures from this standard for fiscal year 2016; additional components used the deemed cost measure from the standard in fiscal year 2017 using a combination of standard price (selling price), latest acquisition cost, estimated historical cost, and historical cost as the basis for valuation.

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 or on a basis that reasonably approximates historical cost 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.

F. Property, Plant, and Equipment

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

SFFAS No. 6 requires general PP&E to be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. PP&E used in government operations are carried at acquisition cost, with the exception of some DOD equipment. In some instances, DOD equipment is valued at estimated historical costs, which are calculated using internal DOD records. To establish a baseline, DOD accumulated information relating to program funding and associated equipment, equipment useful life, program acquisitions, as well as disposals. The equipment baseline is updated using expenditure information and information related to acquisitions and disposals. FASAB issued additional guidance, SFFAS No. 50, which permits a reporting entity to apply an alternative method to establish opening balances for general PP&E and is intended to provide an alternative valuation method when existing systems do not provide a basis for valuation of opening balances in accordance with SFFAS No. 6. During fiscal year 2016, select DOD components implemented this standard; additional components used the alternative valuation methods under the standard in fiscal year 2017 using historical records such as expenditure data, contracts, budget information, and engineering documentation as the method of valuation. SFFAS No. 50 also permits a reporting entity to apply an alternative method to establish opening balances for land and land rights which includes excluding land and land rights from the PP&E opening balance. If this method is applied, future land and land right acquisitions should be expensed. DOD has extensive efforts underway to change asset values to include the exclusion of land and land rights from opening balances in fiscal year 2018.

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 PP&E are assigned useful lives depending on their category. 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 24—Stewardship Land and Heritage Assets.

G. 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.

H. Investments in Government-Sponsored Enterprises

The senior preferred stock and associated common stock warrants in GSEs are presented at their fair value. The annual valuation to estimate the asset's fair value incorporates various forecasts, projections, and cash flow analyses. These valuations are performed on the senior 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 and Concepts for Reconciling Budgetary and Financial Accounting*, as amended. Since the valuation is an annual process, the changes in valuation of the senior 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 the senior preferred stock and warrants are reflected in exchange transactions, any change in valuation is also recorded as an exchange transaction.

The *Housing and Economic Recovery Act of 2008 (HERA)* 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 to support the financial stability of the GSEs. In September 2008, Treasury entered into a Senior Preferred Stock Purchase Agreement (SPSPA) with each GSE. The GSEs were placed under conservatorship and require that Treasury increase their investment in the GSEs' senior preferred stock if, at the end of any quarter, the FHFA, acting as the conservator, determines that the liabilities of either GSE exceed its respective assets. The potential liabilities to the GSEs, if any, are assessed annually and recorded at the gross estimated amount. For more detailed information on investments in GSEs, refer to Note 8—Investments in Government-Sponsored Enterprises.

I. 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 for all Urban Consumers (CPI-U).

J. 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, burial and education benefits, post-retirement health benefits, and post-retirement life insurance benefits, are recorded at estimated present value of future benefits, less any estimated present value of future normal cost contributions. 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 (as well as prior service cost, if any) are recognized immediately in the year they occur without amortization.

The Department of Veterans Affairs (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 these VA pension benefits is a non-exchange transaction and is not required to be recorded on the Balance Sheet. These benefits are expenses when benefits are paid rather than when employee services are rendered.

The liabilities for Federal Employees' Compensation Act (workers compensation) benefits are recorded at estimated present value of future benefits for injuries and deaths that have already been incurred.

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 12—Federal Employee and Veteran Benefits Payable as prescribed by 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*. 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.

K. 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, as well as other environmental contaminations (including asbestos), 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 as well as 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.

L. Insurance and Guarantee Program Liabilities

Insurance and guarantee programs (such as Federal Crop Insurance Program and Benefit Pension Plans Program) 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.

M. Deferred Maintenance and Repairs

Deferred maintenance and repairs are 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 Sheet. However, deferred maintenance and repairs information is disclosed in the unaudited RSI section of this report. Please see unaudited RSI, Deferred Maintenance & Repairs for additional information including measurement methods.

N. Contingencies

Liabilities for contingencies are recognized on the Balance Sheet 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 be incurred, are disclosed in Note 18—Contingencies.

O. 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 19—Commitments describes the components of the government's actual commitments that are disclosed due to their nature and/or their amount. They include long-term leases, undelivered orders, and other commitments.

P. 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 and payable to beneficiaries or service providers as of the reporting date. No liability is recognized for future benefit payments not yet due. For further information, see Note 22—Social Insurance and the unaudited RSI—Social Insurance section.

Q. Funds from Dedicated Collections

Generally, funds from dedicated collections are financed by specifically identified revenues, provided to the government by non-federal sources, often supplemented by other financing sources that 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. The three required criteria for a fund from dedicated collections are:

- A statute committing the government to use specifically identified revenues and/or other financing sources that are originally provided to the government by a non-federal source only for designated activities, benefits, or purposes;
- Explicit authority for the fund to retain revenues and/or other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and
- A requirement to account for and report on the receipt, use, and retention of the revenues and/or other financing sources that distinguishes the fund from the government's general revenues.

For more details on funds from dedicated collections, see Note 20—Funds from Dedicated Collections.

R. 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 Federal Reserve Banks (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 payment systems (including large-dollar transfers of funds, Automated Clearing House (ACH) operations, and check collection), providing certain financial services to federal agencies and fiscal principals, and serving as the U.S. 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 depositary, 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 11—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); and,
- The FRBs are required by Board policy to transfer their excess earnings to the government, which are included in Other Taxes and Receipts on the Statements of Operations and Changes in Net Position.

The government also consults with the FR System on matters affecting the economy and certain financial stabilization activities (Note 4—Loans Receivable and Loan Guarantee Liabilities, Net). 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 exigent circumstances when approved by the Board and the Treasury Secretary.

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 $1,964.7 billion and $1,750.2 billion at September 30, 2017 and 2016, respectively (Note 11—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 https://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 surplus funds not to exceed an FRB's allocated portion of an aggregate of $10 billion for all FRBs. This is in accordance with the provisions of a new statute, *Fixing America's Surface Transportation Act of 2015* (P.L. 114-94). These residual earnings may vary due to, among other things, changes in the SOMA balance levels that may occur in conducting monetary policy. Under P.L. 114-94, if an FRB's earnings for the year are not sufficient to provide for the cost of operations, payment of dividends, or allocated portion of $10 billion aggregate surplus funds limitation, an FRB will suspend its payments to the government until such earnings become sufficient. The FRB residual earnings of $81.3 billion and $115.7 billion for fiscal years ended September 30, 2017 and 2016, 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 General Fund as of September 30, but not collected by the General Fund until after the end of the month. As of September 30, 2017 and 2016, interest receivable on FRB's residual earnings are $0.3 billion and $0.4 billion, respectively (Note 3—Accounts and Taxes Receivables, Net).

Other Related Parties

The federal government, through the FHFA is the conservator for Fannie Mae and Freddie Mac. See Note 8—Investments in 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 since the notes, with maturity dates of 2975 and 2082, are considered fully uncollectible due to the lengthy terms and Amtrak's history of operating losses.

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 to DOT of preferred stock. 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.

In general, Amtrak is not a department, agency, or instrumentality of the government or DOT. Of the 10 members of Amtrak's Board of Directors, eight are appointed by the President and are subject to confirmation by the United States 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 and the President of Amtrak (a nonvoting member) are statutorily appointed to the 10 member board. Traditionally, the Secretary of Transportation has designated the FRA Administrator 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 and purchases from private sector lenders, medium-term and long-term fixed-rate and variable-rate loans guaranteed by Ex-Im Bank to foreign borrowers to purchase U.S. made equipment "export loans".

Ex-Im Bank's credit and guarantee agreement with PEFCO provides that Ex-Im Bank will guarantee the due and punctual payment of interest on PEFCO's secured debt obligations which Ex-Im Bank has approved, and grants to Ex-Im Bank a broad measure of supervision over PEFCO's major financial management decisions, including entitlement to have representatives and attend and participate in all meetings of PEFCO's board of directors, advisory board, and exporters' council, and to review PEFCO's financials and other records. This agreement extends through December 31, 2020.

The contractual agreements provide that Ex-Im Bank will (1) guarantee the due and punctual payment of principal, as well as 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 and Loan Guarantee Liabilities, Net, these guarantees to PEFCO, aggregating $6.4 billion and $5.7 billion at September 30, 2017, and 2016, respectively, are included within the principal amounts guaranteed by the United States. The estimated losses related to these transactions is included within the guaranteed loan liability. Ex-Im Bank received fees for the agreements totaling $0.07 billion and $0.05 billion for fiscal years 2017 and 2016, respectively, which are included as earned revenue on the Statements of Net Cost.

S. Unmatched Transactions and Balances

The reconciliation of the change in net position requires that the difference between ending and beginning net position equals the difference between revenue and 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; and
- Errors and restatements in federal agencies' reporting.

As intragovernmental transactions and balances reduce to immaterial amounts, the corresponding individual lines in the Unmatched Transactions and Balances table are adjusted to remove the differences for the fiscal year. Please refer to the table of Unmatched Transactions and Balances in Other Information (Unaudited) for examples of the individual lines. Materiality for these adjustments is considered in the absolute value, when at or below $0.1 billion.

Refer to the Other Information (unaudited)—Unmatched Transactions and Balances for detailed information.

T. Prior-Period Adjustments

During fiscal years 2016 and 2017, the Pension Benefit Guaranty Corporation (PBGC) and DOD reported prior period adjustments impacting the financial statements. DOD reported an increase of over $37 billion and a $1.5 billion decrease in fiscal year 2017 and 2016, respectively, to beginning net position due to implementation of SFFAS No. 48, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials* and SFFAS No. 50 *Establishing Opening Balances for General Property, Plant and Equipment*. DOD adopted SFFAS No. 48 for stockpile materials for selected components, which is reported in Inventories and Related Property. In addition, DOD adopted SFFAS No. 50 for PP&E for selected components, which is reported in PP&E.

In fiscal year 2016, PBGC's trust fund was reported as a fiduciary activity. During fiscal year 2017, the trust fund was reassessed for fiduciary fund reporting in the *Financial Report*. Based on the reassessment of the guidance within the federal accounting standards and the guidance provided by the establishment of PBGC under the Employee Retirement Income Security Act (ERISA), as amended, and the U.S. Code it was determined that PBGC's trust fund assets and liabilities should be consolidated in the financial statements and not reported as fiduciary activity in the notes. As a result the prior year financial statements were restated thus reversing the change in accounting principle of an increase of $0.1 billion to net position previously reported in fiscal year 2016.

Note 20—Funds from Dedicated Collections included $0.2 billion in prior-period adjustments for Gulf Coast Ecosystem Restoration Council and Department of Housing and Urban Development for fiscal year 2017.

U. Reclassifications

The Railroad Retirement and Black Lung programs are combined on the Statements of Social Insurance (SOSI) in 2016. In previous years, these programs were broken out and displayed separately.

In fiscal year 2017, additional lines were included in the presentation of the Statement of Changes in Cash Balance from Budget and Other Activities to provide a further breakdown of certain categories of transactions.

A review was done to enhance the format and readability of the *Financial Report* leading to consolidation of immaterial lines within tables and removal of information not required by FASAB.

V. Restatements

In fiscal year 2017, the assets and liabilities of PBGC were reassessed for reporting purposes. In fiscal year 2016 PBGC's revolving fund was consolidated in the financial statements and the trust fund was reported as fiduciary activity in the notes. For fiscal year 2017, both funds were consolidated in the financial statements. This change resulted in a correction of errors for the prior fiscal year 2016 financial statements which is reported as a restatement of the amounts on the Balance Sheet, Statement of Net Cost, Statement of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Budget Deficit, Statements of Changes in Cash Balance from Budget and Other Activities, Note 2—Cash and Other Monetary Assets ($3.3 billion increase), Note 3—Accounts and Taxes Receivable ($0.1 billion decrease), Net, Note 7—Debt and Equity Securities ($60.0 billion increase), Note 9—Other Assets ($1.1 billion increase), Note 15—Insurance and Guarantee Program Liabilities ($64.7 billion increase), and Note 16—Other Liabilities ($4.0 billion increase).

In fiscal year 2017, errors were noted in the presentation of Federal Housing Administration's (FHA) fiscal year 2016 Note 4—Loans Receivable and Loan Guarantee Liabilities, Net that required correction of balances reported in fiscal year 2017. The corrections resulted in the restatement of the prior year amounts for FHA's principal amount of loans under guarantee ($2.9 billion increase), principal amount guaranteed by the United States ($2.5 billion increase), and subsidy expense (income) for the fiscal year ($8.1 billion increase).

W. Fiduciary Activities

Fiduciary activities are the collection or receipt, as well as 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 21—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 and credit program receivables, federal employee and veteran benefits payable, credit reform subsidy costs, investments in GSEs, and other non-federal securities and related impairment, tax receivables, loan guarantees, depreciation, imputed costs, other actuarial liabilities, cost and earned revenue allocations, as well as contingencies and any related recognized 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 re-estimates to reflect the most accurate cost of the credit programs to the U.S. Government. *Federal Credit Reform Act of 1990* (FCRA) loan receivables and loan guarantees are disclosed in Note 4—Loans Receivable and Loan Guarantee Liabilities, Net.

The forecasted future cash flows used to determine credit reform amounts 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. Therefore, forecasts of future financial results have inherent uncertainty.

The annual valuation performed as of September 30 on the preferred stock and warrants comprising the Investments in GSEs line item on the Balance Sheets incorporates various forecasts, projections, and cash flow analyses to develop an estimate of the asset's fair value. The value of the senior preferred stock is estimated by first estimating the fair value of the total equity of each GSE (which, in addition to the senior preferred stock, is comprised of other equity instruments including common stock, common stock warrants, and junior preferred stock). The fair value of the total equity is based on a discounted cash flow valuation methodology, whereby the primary input is the present value of the projected quarterly dividend payments. The fair value of the GSE's other equity instruments are then deducted from its total equity, with the remainder representing the fair value of the senior preferred stock. The primary input into the warrants valuation is the market value of the shares of common stock of the GSEs which, along with the junior preferred stock, are traded on the over-the-counter (OTC) Bulletin Board. Treasury evaluates the need for adjusting the OTC market-based valuation of the warrants for the effects, if any, of significant events occurring after the close of the market but before the end of the measurement date. Treasury records any changes in valuation, including impairment, and discloses changes in accordance with SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, as amended. Since the valuation is an annual process, Treasury deems changes in valuation of the preferred stock and warrants as usual and recurring.

Treasury performs annual calculations, as of September 30, to assess the need for recording an estimated liability in accordance with SFFAS No. 5, *Accounting for Liabilities of The Federal Government*, related to the government's funding commitment to the GSEs under the SPSPAs. Liability recognition is predicated on the probable future occurrence of an excess of liabilities and minimum capital reserve amounts, as defined, over the assets of either GSE at the end of any reporting quarter. The occurrence of future GSE deficits, which ultimately determines the liability to the GSEs, is most sensitive to future changes in the housing price index and, to a lesser extent, future changes in guarantee fees received by the GSEs on single family mortgages and interest rates. For more detailed information on investments in GSEs and the amended SPSPAs, see Note 8—Investments in Government-Sponsored Enterprises.

The government offers its employees' pension and other post-employment retirement benefits, as well as life and health insurance. The Office of Personnel Management administers the largest civilian plan and the Department of Defense and Department of Veterans Affairs administer the military plans. Generally the 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, education 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. See Note 12—Federal Employee and Veteran Benefits Payable for additional information.

Y. Credit Risk

Credit risk is the potential, no matter how remote, for financial loss from a failure of a borrower or counterparty to perform in accordance with underlying contractual obligations. The government takes on credit risk when it makes direct loans or guarantees to non-federal entities, provides 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, funding commitments to GSEs, guarantee of money market funds, and other activities. These activities generally focus on the underlying problems in the credit markets. These programs were developed to provide credit where borrowers are not able to get access to credit with reasonable terms and conditions. Because these programs attempt to correct for a market imperfection, it can expose the government to potential 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.