Part I: Management's Discussion and Analysis

Mission: The mission of the Department of the Treasury is to promote the conditions for prosperity and stability in the United States and encourage prosperity and stability in the rest of the world.

History: On September 2, 1789, the First Congress of the United States created a permanent institution for the management of government finances. The Congress assembled the Department of the Treasury and named the following officers: a Secretary of the Treasury, a Comptroller, an Auditor, a Treasurer, a Register, and an Assistant to the Secretary.

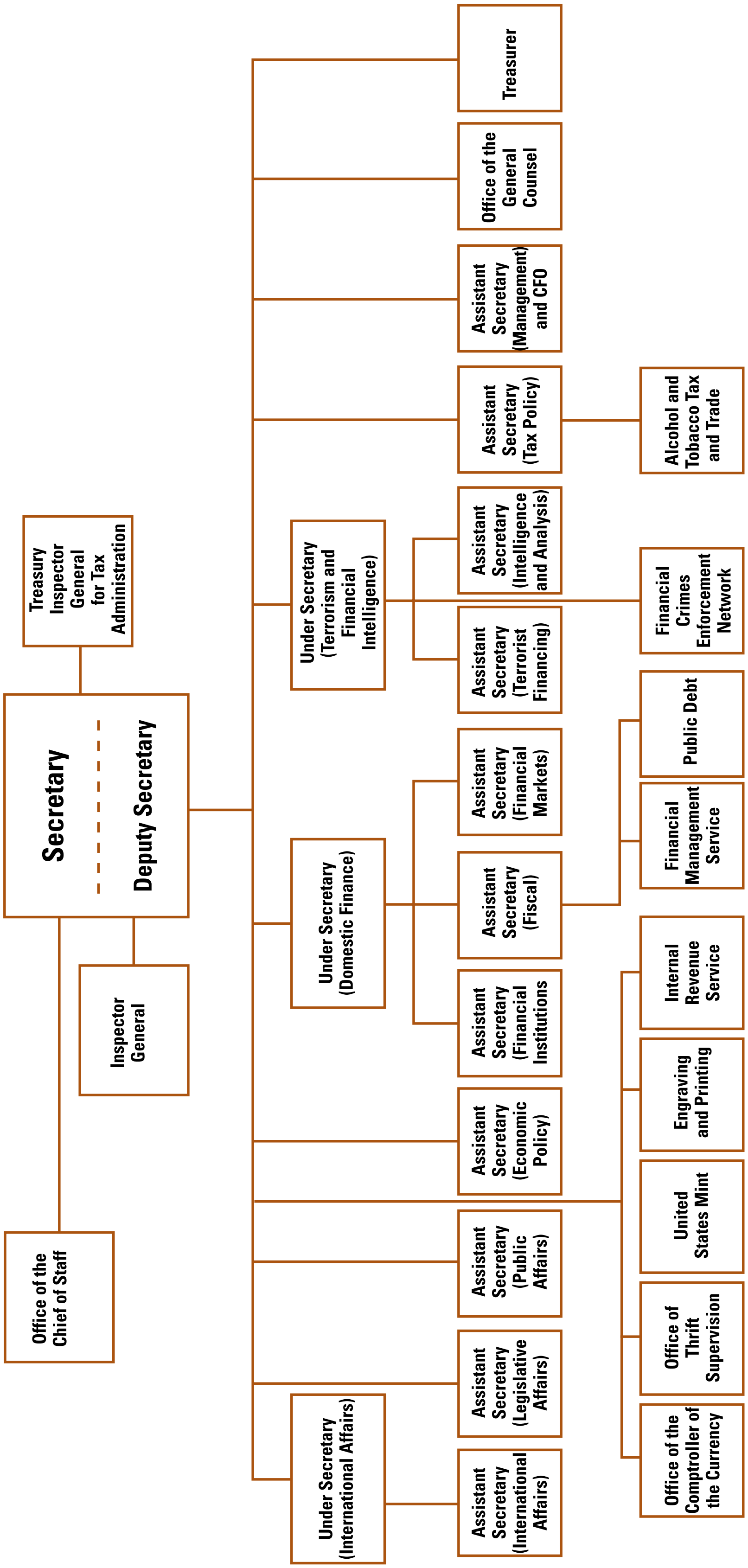
Alexander Hamilton took the oath of office as the first Secretary of the Treasury on September 11, 1789. Hamilton foresaw the development of industry and trade in the United States, and suggested that government revenues be based upon customs duties. His vision also inspired investment in the Bank of the United States, which acted as the government's fiscal agent. Throughout history, the Department of the Treasury has been a dynamic institution of the government's service to the people, expanding to accommodate a growing and ever-changing nation.

Leadership Changes: In FY 2006, the Department of the Treasury had some key leadership changes. During his tenure at the Department of the Treasury, Secretary John Snow worked closely with President Bush to strengthen economic growth and create jobs. In June 2006, Secretary Snow resigned as the Secretary of the Treasury and Henry Paulson was nominated by President Bush to succeed John Snow as the Treasury Secretary. On June 28, 2006, he was confirmed by the United States Senate to serve in the position. Secretary Paulson was officially sworn in at a ceremony held at the Treasury Department on the morning of July 10, 2006. Secretary Paulson previously served as the Chairman and Chief Executive Officer of Goldman Sachs & Company, one of the world's largest and most successful investment banks.

With the departure of Randal Quarles, Under Secretary for Domestic Finance, Robert K. Steel, was nominated by President Bush and confirmed by the United States Senate on September 29, 2006, for this post. The Under Secretary leads Department policy on issues of domestic finance, fiscal policy, fiscal operations, government assets, government liabilities and related economic and fiscal matters. Steel, a native of Durham, North Carolina, retired as vice chairman of Goldman Sachs & Company in New York City, in February 2004 and previously served as the advisory director for the firm.

James Wilkinson replaced Christopher A. Smith as the Chief of Staff to the Secretary of the Treasury. In his current position, Wilkinson is responsible for overseeing the day-to-day operations of the Department and coordinating policy development and review with other agencies and the White House, as well as assisting in setting the overall strategic direction of the Department. He is also responsible for advising the Secretary on a wide variety of policy and management issues on economic and market conditions.

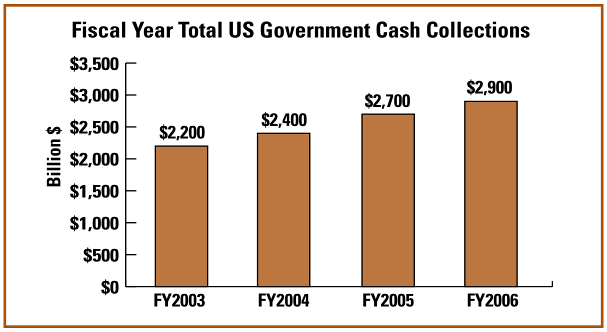
DEPARTMENT OF THE TREASURY



Operations Highlights

In FY 2006 the Treasury Department…

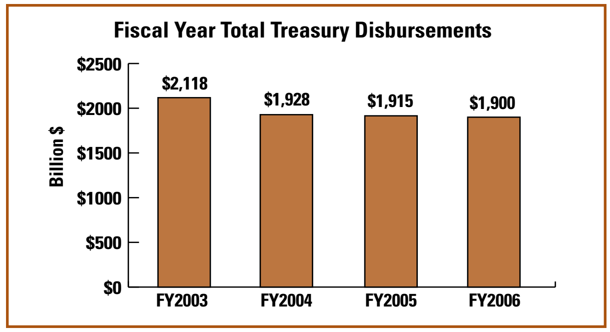
Collected



Fiscal Year Total US Government Cash Collections

- US Government Receipts: $2.6 trillion
- Delinquent Debt Collected: $3.336 billion
- Collected through the Electronic Federal Tax Payment System: $1.9 trillion
- Enforcement revenue collected from all sources was at a record level of: $48.7 billion

Disbursed

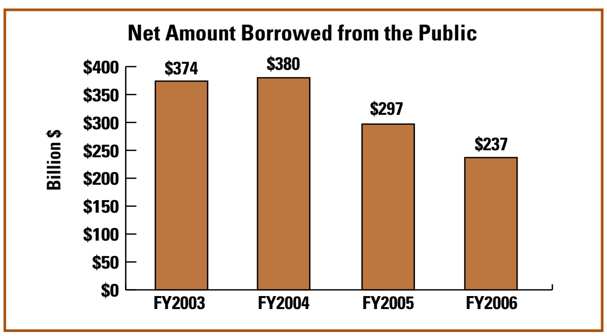


Fiscal Year Total Treasury Disbursements

- Total Treasury Disbursements: $1.9* Trillion
- Volume of electronic disbursements made through Treasury's Regional Finance Centers: 745 million
- Volume of check payments made through Treasury's Regional Finance Centers: 219 million

* **Treasury Disbursements only**

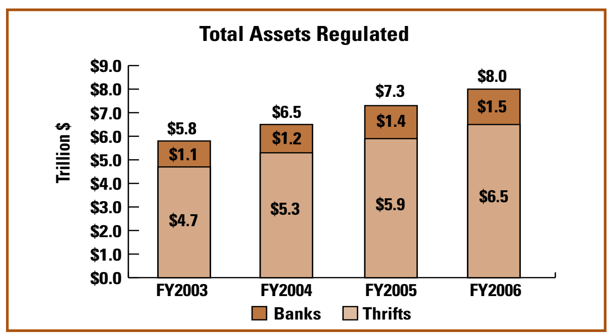
Borrowed



Net Amount Borrowed from the Public

- Net Amount Borrowed from the Public: $237 billion
- Marketable Treasury Securities auctioned and issued: $4.4 trillion
- Non-Marketable Treasury Securities Issued to the public and government accounts: $32 trillion
- Number of Savings Bonds Issued: 32 million
- Interest Paid by Treasury (including interest credited to Trust Fund): $406 billion

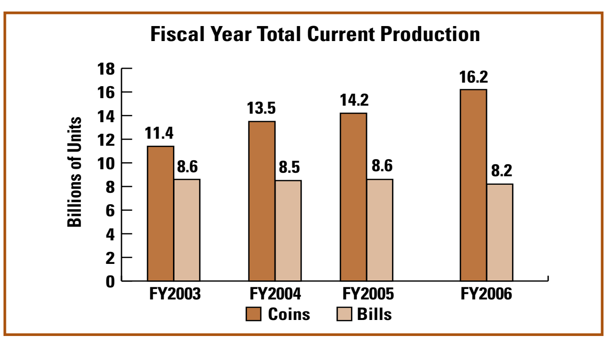
Regulated



Total Assets Regulated

- Number of National Banks Regulated: 1852
- Number of Federal Branches Regulated: 49
- Number of Thrifts and Savings Associations Regulated: 854

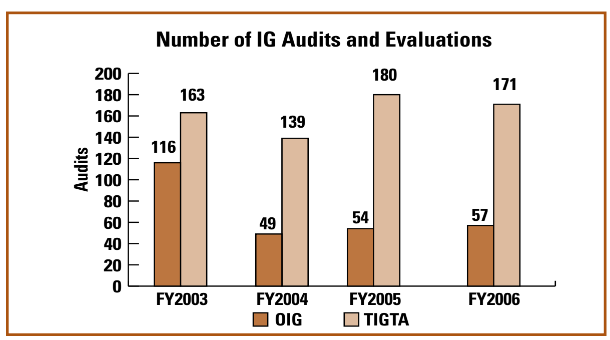
Manufactured



Fiscal Year Total Current Production

- Produced 8.2 billion currency notes
- Produced 16.2 billion coins

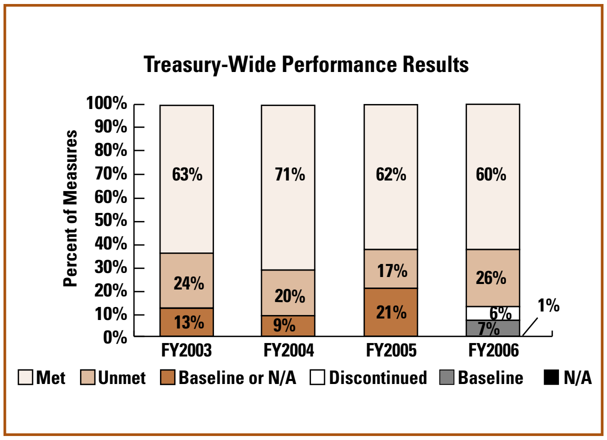
Assured

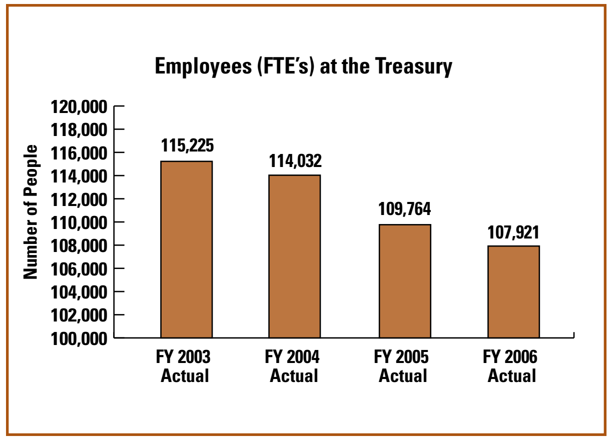


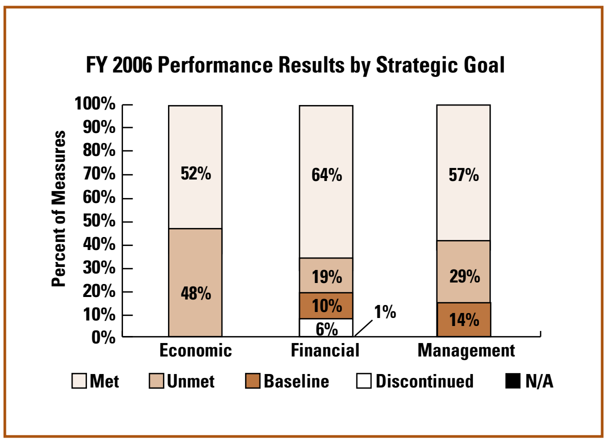
Number of IG Audits and Evaluations

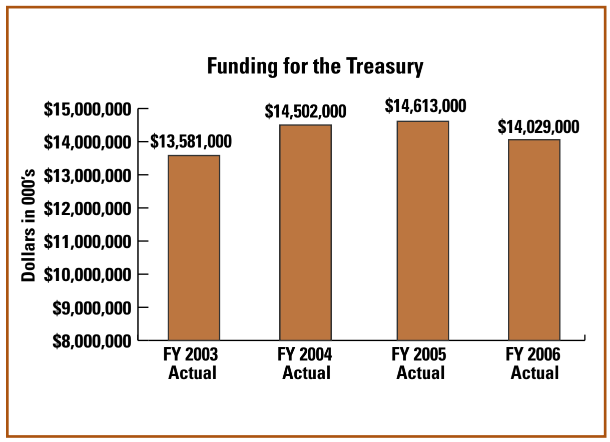
- Performed 228 audits and evaluations through the efforts of the Inspectors' General

Performance Highlights





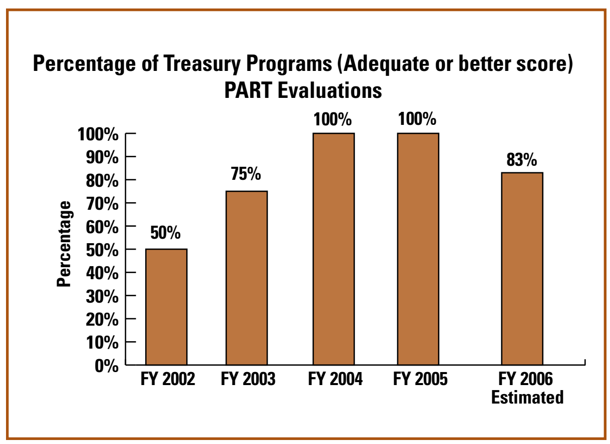




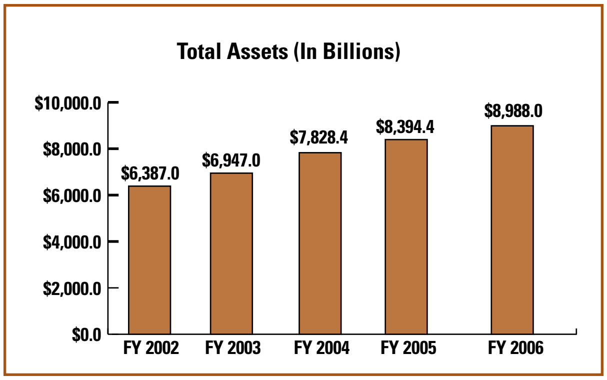
President's Management Agenda

Initiative	Status		FY 2006 Progress			
	FY 2005	FY 2006	Q1	Q2	Q3	Q4
Human Capital	Y	G	G	G	G	G
Competitive Sourcing	G	G	G	G	G	Y
Financial Performance	R	R	G	G	G	G
E-Government	R	Y	Y	G	Y	Y
Budget Performance Integration	Y	Y	G	G	Y	Y
Improper Payments	R	R	Y	Y	Y	Y

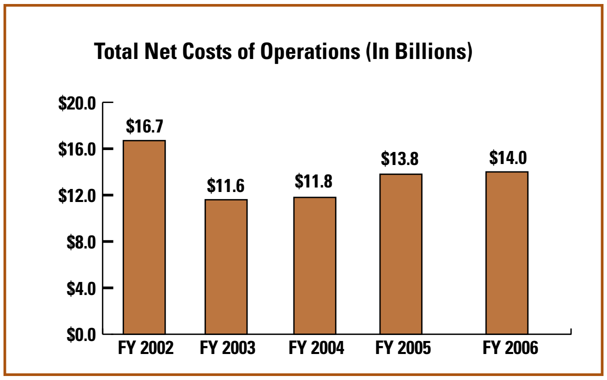
Green for Success Yellow for Mixed Results Red for Unsatisfactory



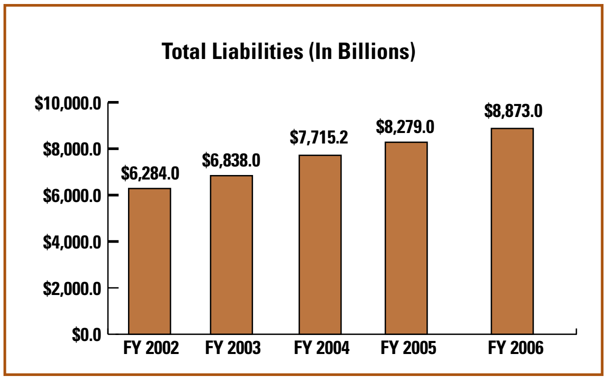
Financial Highlights



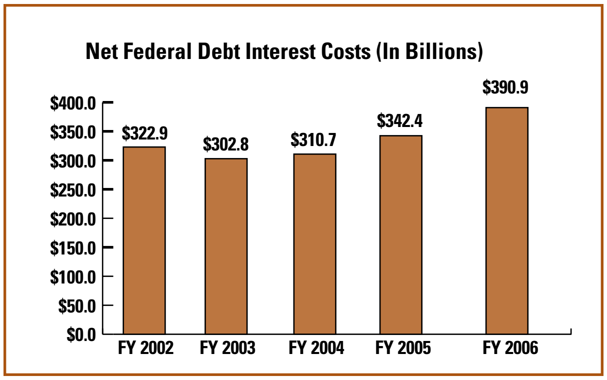
The increase in total assets from $8.4 trillion in FY 2005 to $9.0 trillion in FY 2006 is largely due to the increase in future funds required from the General Fund of the U.S. Government to pay for the federal debt.



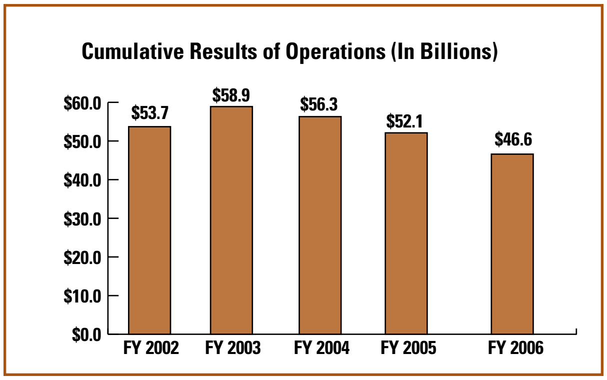
The increase of total net cost of operations from $13.8 billion in FY 2005 to $14.0 billion in FY 2006 is largely in the economic and financial programs and is primarily due to exchange rate fluctuations, reduced interest income, write offs of discontinued projects, and increased payments to financial agents.



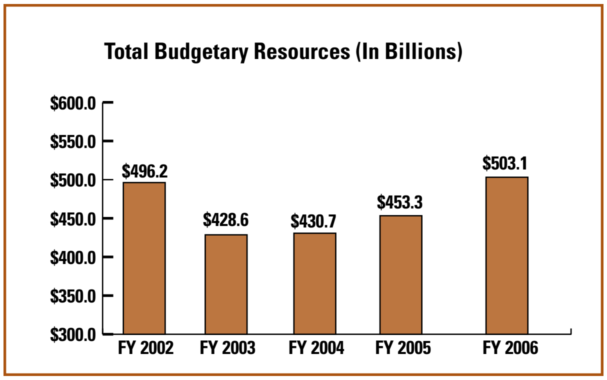
The borrowing from other federal agencies and debt issued to the public increased from $8.0 trillion in FY 2005 to $8.5 trillion in FY 2006.



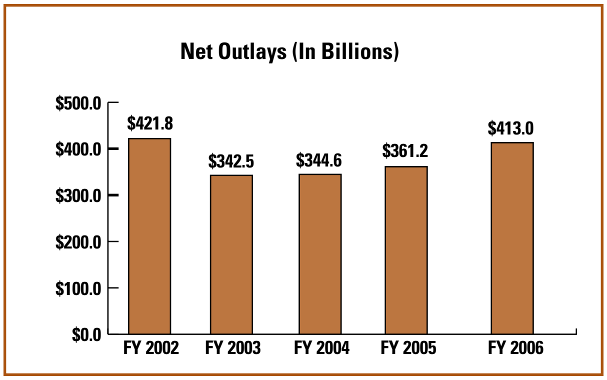
The net interest paid on the federal debt rose from $342.4 billion in FY 2005 to $390.9 billion in FY 2006 is due to the increase in the debt and higher interest rates.



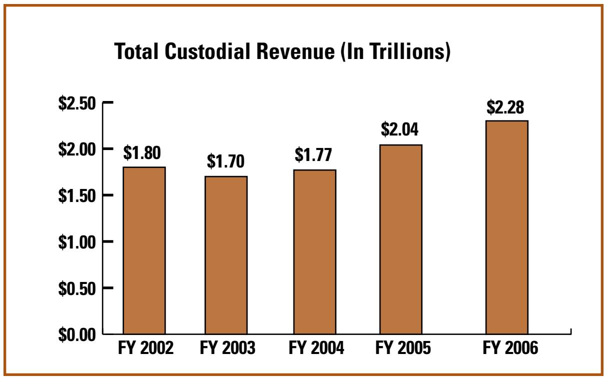
The net decrease of $5.5 billion in the cumulative results of operations from $52.1 billion in FY 2005 to $46.6 billion in FY 2006 was largely due to the decrease in Treasury's reserve position in the International Monetary Fund due to loan repayments by debtor countries.



The majority of the increase in total budgetary resources from $453.3 billion in FY 2005 to $503.1 billion in FY 2006 was due to the increase in funding to pay for the interest on the federal debt. The sharp increase in the budgetary resources for FY 2002 was the result of a restatement to reflect a change in accounting principles for the interest on public debt securities as directed by the Office of Management and Budget.



The majority of the increase in net outlays from $361.2 billion in FY 2005 to $413.0 billion in FY 2006 also was due to the increase in interest payments.



Total custodial revenue collected on behalf of the U.S. Government increased from $2.04 trillion in FY 2005 to $2.28 trillion in FY 2006. The majority of the increase is attributed to the rise in individual and corporate income taxes due to increased economic activity.

Note: Prior to March 1, 2003, Treasury bureaus also included Bureau of Alcohol, Tobacco and Firearms; Federal Law Enforcement Training Center; U.S. Customs Service; and U.S. Secret Service. These bureaus were divested to either the Department of Homeland Security or Department of Justice. FY 2003 and prior years include data for these bureaus.

Management's Discussion and Analysis

Executive Summary

The Department of the Treasury shoulders a great responsibility for the American people. While the Department performs a critical role in U.S. and global economies, it continually evolves to meet the ever changing needs of the nation. The Treasury Department provides cash management for the federal government, currency and coin production, administration of the tax code, oversight of the financial sector, and plays an integral role in stopping the financing of terrorism, and identifying and dismantling the support networks of terrorist organizations.

In fiscal year 2006, the Department's debt financing operations auctioned and issued more than $4 trillion in marketable securities, and $32 trillion in non-marketable securities, to the public and government. The Treasury Department also oversaw a daily cash flow of almost $60 billion, distributed 85 percent of federal payments worth $1.5 trillion, produced 8.2 billion currency notes, and 16.2 billion coins. The cost per 1,000 notes delivered was reduced by $1.34, while the cost of producing coins rose from $7.42, in FY 2005, to $7.55, in FY 2006, missing the very aggressive target of $6.62. The Department continued its efforts as the lead in the U.S. delegation to the Financial Action Task Force (FATF), the international standard setting body charged with safeguarding the global financial system against money-laundering and terrorist financing, yielding results, such as impeding access to funds and the financial system by terrorist groups such as al Qaida and Hamas and limiting North Korea's ability to abuse the international financial system to support its proliferation and illicit activities.

Collecting Taxes

> ***"The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. It is the need to reduce that gap that drives much of what we do. This is true not only from a revenue standpoint, but also from a taxpayer fairness perspective. Our tax system is largely based on voluntary compliance and that compliance is enhanced if taxpayers believe that everyone is paying their fair share."***
>
> Mark Everson
> IRS Commissioner
> April 6, 2006

Critical to managing the Federal Government's finances effectively is collecting federal tax revenue. The Department of the Treasury collected $2.5 trillion in federal tax revenue, with a record $48.7 billion collected through enforcement activities. Total collections of tax revenue increased 11 percent and enforcement revenue increased 3 percent over last year.

Compliance: While most taxpayers voluntarily comply with their tax obligations, some do not; noncompliance results in a tax gap. In FY 2006, the IRS updated its tax gap estimates. New estimates show that underreporting of income taxes, employment taxes, and other taxes account for about 80 percent of the tax gap. The Treasury Department is focusing on corrosive activities of high-risk taxpayers including corporations, high-income taxpayers, and promoters of abusive tax avoidance transactions (ATAT) and other major violators of the tax code. Targeting high-risk taxpayers improves IRS efficiency, reduces the burden on compliant taxpayers, and concentrates enforcement presence where it is needed most.

Free Tax Assistance For You by Volunteers. For the past seven years, the IRS in Atlanta has partnered with Kroger grocery stores and the Georgia Department of Revenue to sponsor "Midnight Madness" on the last day of the tax filing season. IRS volunteers accept tax returns and extensions, provide tax forms, and answer tax questions at various Kroger store locations.

Taxpayer Outreach: Expanding education and outreach helps the public understand their filing, tax reporting and payment obligations, and improves voluntary compliance. The Department continues to expand its outreach by relying on partner organizations such as state taxing authorities and a cadre of volunteer groups to serve taxpayer needs. Through its 12,300 Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites, the Department provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. The 69,000 volunteers located at the sites prepared approximately 2.3 million returns, a 7.3 percent increase over FY 2005.

Taxpayer Burden Reduction: The taxpayer burden measures time and out-of-pocket expense taxpayers incur in meeting their tax responsibilities. The complexities of the tax laws and the taxpayer's familiarity and skills with tax return preparation (paper/electronic) have a significant impact on burden. Many taxpayers find it more convenient and beneficial to prepare tax returns electronically or use a tax preparer. The estimated FY 2006 burden was 6.7 billion hours, compared to 6.4 billion hours, in FY 2005, an increase of 251 million hours, resulting from changes to existing forms dictated by ten different laws enacted in 2005. The IRS continues to partner with external stakeholders including taxpayers, practitioners, citizens groups, software developers, and state/federal agencies to receive suggestions on reducing taxpayer burden while designing forms more suitable for computer usage.

Tax Reform: The President's Advisory Panel on Federal Tax Reform issued its report in November 2005, entitled "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System." The Panel recommended two options for fundamental reform of the Federal tax system. The Department of the Treasury is evaluating the Panel's report and is considering options for reform. In September 2006, the Department announced a comprehensive strategy for reducing the tax gap which includes the simplification and reform of the tax law to reduce unintentional errors caused by a lack of understanding, and to reduce opportunities for intentional evasion of tax liabilities. The Administration's FY 2007 budget included six proposals to simplify the tax treatment of savings and families by consolidating existing programs and clarifying eligibility requirements. The Office of Tax Policy is developing other simplification proposals for future consideration. These tax reform initiatives continue to be supplemented by IRS efforts to reduce taxpayer burden by simplifying forms and procedures.

Managing U.S. Government Finances

In addition to collecting taxes, the Department of the Treasury oversees the daily cash flow of almost $60 billion and distributes 85 percent of all federal payments. Managing the government's finances also includes making payments, issuing debts, and preparing public financial statements.

Federal Payments: The Treasury Department functions as the nation's disburser, manager, and accountant of public monies by distributing payments and financing public services. In FY 2006, the Treasury Department made 100 percent of its payments accurately and on-time, including income tax refunds, Social Security benefits, veterans' benefits, and other federal payments. The Department continued to transition from paper checks to electronic transactions issuing 77 percent of 964 million non-Defense payments electronically. In FY 2006, the Treasury Department continued to expand and market the use of electronic media to deliver federal payments, improve service to payment recipients, and reduce government program costs. These efforts helped to decrease the number of paper checks issued and minimize costs associated with postage on the re-issuance of lost, stolen or misplaced checks. Financial Management Service (FMS) issued over 8.5 million fewer checks than last year and through its Go-Direct campaign, converted over 600,000 individuals from checks to direct deposit in the first full year of the campaign. If the more than 154 million benefit checks issued in FY 2006 (142 million were Social Security and Supplemental Security Income payments) were converted to direct deposit, the savings to the American taxpayer would be $119 million.

In FY 2006, FMS collected receipts totaling $2.9 trillion of which $1.8 trillion was collected through the Electronic Federal Tax Payment System. FMS has been working actively to reduce the unit cost of processing Federal revenue transactions. The overall cost efficiency of the collections business line has improved dramatically as a result of these efforts.

Debt Management: The Treasury Department determines and executes the federal borrowing strategy to meet the monetary needs of the government at the lowest possible cost. Each year, the Treasury Department borrows and accounts for trillions of dollars needed for the government to function. The Department conducts debt financing operations by issuing and servicing Treasury securities. In FY 2006, more than $4 trillion in marketable securities and $32 trillion in non-marketable securities were issued to the public and government accounts. The Department of the Treasury met its performance goal of announcing Treasury auction results within its target timeframe 100 percent of the time. The Department minimized the cost of borrowing; with a shorter release time, exposure to adverse market movements and the implicit market premium are reduced. The Department improved efficiency in the Government Agency Investment Services (GAIS) program. GAIS supports federal, state, and local government agency investments in non-marketable Treasury securities and manages over $3.7 trillion in customer assets. In FY 2006, over 97 percent of GAIS transactions were conducted online, as compared to 72.7 percent in FY 2005.

Treasury Hunt Expanded

Treasury Hunt is a tool available on Public Debt's website (*www.TreasuryDirect.gov*) that helps people determine if they have matured savings bonds that have stopped earning interest or if Public Debt is holding savings bonds or interest payments that were returned as undeliverable. Treasury Hunt encourages people to redeem their matured savings bonds and put their money back to work. Over the past year, Public Debt greatly expanded the number of matured savings bond records available for searching by taxpayer identification number to more than 12 million. Each month, bonds that have newly matured are added to the Treasury Hunt database, making it worthwhile for bond owners to visit the site often.

Focusing Domestically

To achieve conditions promoting prosperity and stability in the U.S. and world economies we must stimulate economic growth. This is accomplished through the development of policies addressing overall economic development, implementing pro-growth tax programs, regulating banking and financial institutions, advocating for free and fair trade, promoting assistance programs in distressed communities, expanding opportunities for American businesses and workers in the global economy, creating good jobs with mobility and wage growth, averting or mitigating financial crises and, in general, accelerating and sustaining the economic performance of the nation. Modernizing entitlement programs before they destabilize the economy is a critically important aspect of this, as is keeping the economy performing at peak potential by encouraging and supporting American competitiveness through innovation.

Treasury supports trade liberalization and budget discipline through its role in negotiating and implementing international agreements pertaining to official export subsidies. The Treasury Department secured agreements in the Organization for Economic Cooperation and Development that reduced subsidies in export credits and tied aid flows valued at over $70 billion. These agreements open markets, leveled the playing field for U.S. exporters, and saved the U.S. taxpayer about $800 million. Cumulative budget savings from these agreements are estimated at over $11 billion since 1991.

Economic Policies: The Department of the Treasury develops and implements economic policies to stimulate economic growth and job creation. While drawing a direct relationship between the Department's actions and economic indicators is difficult, the Department's policy makers have helped create an environment conducive to strong economic growth and a healthy labor market. In FY 2006, growth in the real Gross Domestic Product (GDP), the broadest measure of the economy's performance, was relatively unchanged from FY 2005, at 3.3 percent. The solid pace of expansion contributed to job creation and helped lower the unemployment rate from an average of 5.2 percent in FY 2005, to 4.8 percent in FY 2006.

Capital Market Competitiveness: To ensure the American economy remains a model of strength, flexibility, and resiliency, it must grow and remain competitive. Strong capital markets play an important part in facilitating economic growth. The Department's efforts are aimed at preserving the integrity of the nation's markets while keeping pace with the dynamic U.S. economy and financial marketplace, which is increasingly competitive and integrated on a worldwide level. Capital markets competitiveness is influenced by many factors, some of which the Department will focus on, include regulatory, legal and accounting systems. In addition, the Treasury Department will address longer term issues that impact the economy including energy, entitlement reform, and trade.

Free Trade and Investment: The United States seeks strong commitments from its trading partners to ensure their goods and services markets are available to the U.S. on an open basis under transparent and fair rules. The Department helps negotiate international agreements to remove trade and investment barriers, which enhance global market efficiency and increase job and business opportunities for Americans. The Department is responsible for the financial services negotiations on banking and securities issues. Once implemented these agreements serve as an element of our trading partners economic infrastructure that enhance international economic and financial stability. Negotiations are conducted through either the World Trade Organization or U.S.-initiated bilateral and regional Free Trade Agreements (FTA) and Bilateral Investment Treaties (BIT).

In FY 2006, the Department of the Treasury implemented FTAs and completed negotiations with nine countries in the Middle East and Latin America. The United States and Vietnam concluded their bilateral agreement on goods and services. FTA negotiations were launched with Malaysia and Korea. Each of the FTAs opened markets to U.S. goods and services, including financial services, and promoted open investment regimes.

BITs and the investment provisions in FTAs contain stipulations that help ensure the most efficient and effective use of capital and provide the legal framework to enhance investor confidence, economic growth and greater opportunities for American workers and employers. In its ongoing efforts to expand BITs with other nations, the Treasury Department continued to negotiate a formalized agreement with Pakistan based on the model developed in FY 2004. In addition, this year, Congress ratified a BIT with Uruguay.

The Free Trade Agreements (FTA) that were concluded since 2001, and combined with three earlier accords, now roughly cover $925 billion in two way trade – nearly 36 percent of the total U.S. trade with the world and 45 percent of our exports. Where we have a FTA, our exports are growing a healthy 20 percent per year on average, more than twice the rate of growth for our exports where we do not have a FTA.

Supervising National Banks and Savings Associations: The Department of the Treasury is the primary regulator and supervisor of national banks, savings associations and savings and loan holding companies; and works to streamline licensing and supervisory procedures and keep regulations current. Effective supervision promotes competitive financial services, consistent with safety and soundness.

Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), federal bank and thrift regulations are reviewed at least once every ten years in an effort to eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome. As part of the EGRPRA, banking agencies continued their joint initiative to review and recommend the elimination of unnecessary regulations to Congress. Results of the initiative identified over 125 regulations and over 1,000 letters were received with suggested changes.

Congress passed and President Bush signed into law the "Financial Services Regulatory Relief Act of 2006", which provides regulatory burden relief for the financial services, and the banking and thrift industries. The law allows regulators to adjust exam cycles of healthy institutions for greater efficiency, modernizes record keeping requirements for regulators, and requires the federal banking agencies to propose within six months a simple, uniform privacy notice to comply with the Gramm-Leach-Bliley Act of 1999.

American homebuyers now have more financing options than ever before, with a menu of mortgage related products that offer a variety of maturities, interest rates and payment structures. In recent years, a combination of forces – especially the rapid increase in house prices – has led to the increased popularity of so-called non-traditional mortgage products. Understanding the tradeoffs of these products is essential if a borrower is to make an informed decision about one of their most important financial assets. To address these concerns, the OCC, OTS, the Federal Reserve Board, FDIC, and NCUA, published guidance on these nontraditional products. The guidance stresses the importance of carefully managing the risk associated with these loans, and clarifies how banks, thrifts, and credit unions can offer them in a safe and sound manner, with appropriate disclosure given to the borrower. The Treasury Department continues to promote homeownership and healthy, stable communities by ensuring that financial institutions have the means to provide consistent, reliable housing financing to credit worthy borrowers.

Creating Opportunity in Native Communities: The Treasury Department, through the Community Development Financial Institutions (CDFI) Fund, has a number of initiatives designed to overcome barriers preventing access to credit, capital and financial services in Native American communities. The Native Initiatives seek to increase the number and capacity of CDFIs serving Native communities. In FY 2006, the CDFI Fund issued $4.3 million in Native Initiative awards to 23 CDFIs, and Native CDFI awardees' reported asset growth of 182 percent, far exceeding the 33 percent projection. This asset growth represents required timely reporting of performance data to the Fund by 7 Native CDFI awardees. Most organizations experienced growth and one start-up CDFI had a ten-fold increase in its assets.

As an example, the Four Bands Community Fund, of Eagle Butte, South Dakota, is a certified Community Development Financial Institution serving the Cheyenne River Indian Reservation and a CDFI Fund awardee. In 2006, Four Bands received $618,000 from the CDFI Fund to continue to assist entrepreneurs on the Reservation with training, business incubation, and access to capital to encourage economic development for low-income residents. Four Bands recently introduced a new Credit Builder Loan to help new clients improve their credit worthiness and position themselves for the micro and small business loan products that Four Bands offers. With the Credit Builder Loan, clients are required to create and implement a Credit Builder Action Plan to repair their credit histories and develop a positive credit relationship with the organization. "Four Bands is not like a bank. They teach you the steps to succeed and then provide loan support," says Eva Gilbert, proud owner of Eva's Hair and Nails on the Reservation.

Financial Assistance Awardees Exceed Leverage Goal: The CDFI Fund's Financial Assistance component gives financial awards to CDFIs that demonstrate the greatest ability to leverage non-federal dollars which support comprehensive business plans that create community development impact in underserved markets. In FY 2006, the Fund made $24 million in Financial Assistance awards to CDFIs that primarily serve rural and urban low-income communities. In addition, awardees leveraged the Fund's award dollars with $1.4 billion in private and non-CDFI Fund dollars, therefore significantly exceeding the $1.1 billion leveraging goal and marking this the second consecutive year the goal was surpassed. The leverage ratio of $27 of private and non-CDFI Fund dollars for every $1 of Financial Assistance awards held constant from FY 2005 to FY 2006.

Bank Enterprise Award (BEA) Program: The BEA Program provides insured depository institutions with financial incentives to expand investments in CDFIs and increase direct lending, investment, and service activities in economically distressed communities. The BEA Program provided modest monetary awards for large increases in community development, thereby leveraging the CDFI Fund's dollars and putting more capital to work. BEA applicants showed an increase of over $318 million in community development activities from FY 2005 to FY 2006, surpassing the CDFI Fund's goal of $81 million by nearly 293 percent.

ACCION-New Mexico is a certified CDFI and CDFI Fund awardee whose mission is to break down barriers to credit for emerging entrepreneurs whose small capital needs, credit history, or lack of collateral may prevent them from qualifying for bank financing. ACCION-New Mexico has helped create or sustain more than 3,400 jobs by providing thousands of loans to small businesses and micro-enterprises in the state. Its average loan size is just $5,300. One borrower - the owner of Carniceria La Especial, a grocery and meat market in Albuquerque – put it this way: "ACCION-New Mexico believed in me when no one else would."

Focusing Internationally

The Department of the Treasury plays an important role in the global economy, monitoring over 160 economies to help ensure stability and transparency in the global marketplace. The Department works with foreign governments, financial institutions and international organizations to promote free and fair trade practices, target development assistance, identify global financial trends, and expand prosperity in the United States and around the world.

Multilateral Debt Relief Initiative (MDRI) for the Heavily Indebted Poor Countries: In July 2006, President Bush and other G8 leaders endorsed MDRI debt relief for Heavily Indebted Poor Countries. The Department of the Treasury developed and successfully negotiated the financial structure of an agreement which will result in 100 percent cancellation of debt obligations owed the International Development Association, African Development Fund, and International Monetary Fund by eligible countries. Under the agreement, 22 countries are currently eligible to receive $34 billion in relief, with an additional 16 countries eligible once they reach "Completion Point." Total relief provided is approximately $52 billion.

Egypt: The Department of the Treasury, in cooperation with the State Department and U.S. Agency for International Development, negotiated an agreement with the Government of Egypt to tie the disbursement of U.S. foreign assistance to Egypt's implementation of a series of reforms designed to modernize its financial sector. As a result, Egypt began the process of privatizing state-owned banks, resolving bad loans, and increasing the efficiency of the foreign exchange market. These reforms boosted investor confidence in Egypt and contributed to strengthening economic growth - up from 4.1 percent in 2004 to 5.7 percent in the first half of 2006. If maintained, this growth will boost job creation and help protect Egypt against economic shocks as it opens its markets.

Brazil: The largest economy in Latin America continued a strong recovery from the financial crisis of 2002, during which the United States supported International Monetary Fund assistance to stabilize Brazil's economy. From August 2005 through July 2006, Brazil's economy created 413,000 new jobs. During the Treasury Department's consultations with Brazil, in July 2006, discussions focused on the global outlook, the benefits of increased trade openness, strategies to increase investment in productive infrastructure, and policies promoting research and innovation.

Secretary Paulson in China

Secretary Paulson visited China in September 2006. The Strategic Economic Dialogue that was established through this meeting will help to ensure the two countries can address future critical economic challenges, including: building innovative societies, seizing the opportunities for global economic integration to assure sustained growth, and the economics of energy and conservation. The United States will also support China in its goal of building a consumer-driven economy rooted in open markets.

Fighting Terrorism and Financial Crime

The Department of the Treasury is a key player in the Government's efforts to track and cut off the flow of funds to terrorists and other national security threats. In strong partnership with the Departments of Justice, State, and Homeland Security, as well as the Intelligence Community, the Department utilizes a range of financial intelligence and enforcement authorities to prevent the flow of funds to terrorist organizations.

The Office of Terrorism and Financial Intelligence (TFI), created in 2004, align the Department's national security resources and authorities, and deploy them in a coordinated and focused manner against security threats. TFI unifies leadership for the functions of:

- The Office of Intelligence and Analysis (OIA)
- The Office of Terrorist Financing and Financial Crimes (TFFC)
- The Financial Crimes Enforcement Network (FinCEN)
- The Office of Foreign Assets Control (OFAC)
- The Treasury Executive Office for Asset Forfeiture (TEOAF).

The Department's range of activities against national security threats include: (1) intelligence analysis on the financial and other support networks for terrorist groups, weapons of mass destruction (WMD) proliferators, and other serious national security threats, (2) promoting international cooperation to attack the financial foundation of national security threats, (3) improving the transparency and safeguards of financial systems, and (4) targeting and sanctioning supporters of terrorism, WMD proliferators, narcotics traffickers, and other threats.

Safeguarding the nation's financial system through Bank Secrecy Act: The Department of the Treasury effectively administers and enforces the Bank Secrecy Act (BSA), an important weapon in combating anti-money laundering. The BSA requires financial institutions to make reports of suspicious activities available to law enforcement, keep records, and establish appropriate internal controls to guard against financial crime. As administrator of the BSA, the Department oversees and coordinates the sharing of financial intelligence and analysis with its stakeholders, and works closely with regulatory partners to take action against violating institutions, such as imposing stiff monetary penalties.

> FinCEN has completed three major geographic threat assessments of financial activity in states along the U.S. southwest border, to support federal and state drug and cash interdiction efforts. These assessments, which are based on analysis of more than 400,000 BSA reports filed in border counties, identified potential money laundering hotspots and significant changes in financial activity to help federal and state authorities allocate resources on the southwest border.

Enforcing Sanctions: The Office of Foreign Assets Control (OFAC) administers and enforces economic and trade sanctions against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. In FY 2006, OFAC, in response to the Administration's policies, pursued designations of entities engaged in the proliferation of weapons of mass destruction, continued their efforts to expose terrorist networks, and built on their success in dismantling networks associated with drug cartels. OFAC worked with the Office of Intelligence and Analysis to pursue designations targeting terrorist groups and their supporters. In addition, OFAC worked closely with the Departments of State and Justice to identify targets for four newly established sanctions programs, including Sudan's Darfur region, Côte d'Ivoire, Belarus, and the Democratic Republic of Congo.

Producing Coins and Currency

The Treasury Department ensures the U.S. financial system's reliability and security through the production of the nation's coins and currency. The Department manufactures circulating coinage and popular numismatic products, and the nation's paper currency. The Department of the Treasury also engages in research and development to design next generation currency that guards against counterfeiting.

The Department had revenue and other financing sources of $2.3 billion for FY 2006, for both circulating and numismatic coin products, a 31 percent increase over FY 2005. As a result of operations, $750 million was returned to the Treasury General Fund, compared to $775 million in FY 2005. This reduction in transfer was due primarily to significant increases in the price of metal used for coin fabrication.

In FY 2006, the cost per 1,000 coin equivalents increased about two percent to $7.55, from $7.42 in FY 2005, missing the aggressive target of $6.62. Cycle time increased slightly from 69 days, in 2005, to 72 days, in 2006. This increase had no effect on the overall program or activity performance. Rising metal prices had a significant impact on production cost, causing the penny and the nickel to cost more than their face value. The Treasury Department is working with Congress to evaluate alternative materials to reduce production cost.

> The Mint's numismatic and bullion sales increased from $588.2 million in FY 2005, to $1.03 billion in FY 2006. Particularly noteworthy was the introduction of the first ever U.S. Government issued 24-karat gold coin.

In FY 2006, the Department streamlined its operations to reduce the cost of producing currency notes. Manufacturing costs per 1,000 notes produced decreased from $28.83, in FY 2005, to $27.49, in FY 2006; and security costs were favorable at $6.00 per thousand notes produced, against a performance target of $6.25 per thousand notes delivered. In FY 2006, the currency program was completed below standard costs.

The currency production program specifically addresses the nation's need for counterfeit-deterrent currency by applying the latest technologies in security printing and processing. This fiscal year, the Treasury Department introduced the redesigned $10 note which followed the successful introductions of the redesigned $20 and $50 notes in 2003 and 2004, respectively; redesigns of the $5 and $100 notes are scheduled for circulation in 2008 and 2009. The new notes are part of the current multi-year initiative to implement the most ambitious currency redesign in U.S. history. Due to the Department's consistent automated inspection equipment, more than 99 percent of all notes delivered to the Federal Reserve met or exceeded their exacting quality standards.

Improving Management Efficiency and Effectiveness

The Treasury Department ensures that taxpayers receive the most efficient and effective use of their tax dollars by building a strong institution that is citizen-centered, results-oriented, and actively implements the principles of the President's Management Agenda (PMA).

PMA: The PMA is designed to improve management practices across the federal government and transform government into a results-oriented, efficient and citizens-centered enterprise. Implementing the PMA involves: (1) lowering the cost of doing business through competition; (2) strengthening the Department's workforce; (3) improving financial performance; (4) increasing the use of information technology and e-government capabilities; and (5) integrating budget decisions with performance data.

The Office of Management and Budget assesses each agency's status and progress for the PMA initiatives on a quarterly basis. Initiative "status" describes overall success, and "progress" describes ongoing efforts to meet PMA goals.

In FY 2006, the Department continued to be successful in two initiatives, Competitive Sourcing and Human Capital; in the E-Government initiative, the status score went up; while Budget Performance, Improper Payments, and Financial Performance initiatives remained unchanged. Some initiatives showed progress by increasing the score one level for the quarterly rating.

President's Management Agenda

Initiative	Status		FY 2006 Progress			
	FY 2005	FY 2006	Q1	Q2	Q3	Q4
Human Capital	Y	G	G	G	G	G
Competitive Sourcing	G	G	G	G	G	Y
Financial Performance	R	R	G	G	G	G
E-Government	R	Y	Y	G	Y	Y
Budget Performance Integration	Y	Y	G	G	Y	Y
Improper Payments	R	R	Y	Y	Y	Y

Green for Success   Yellow for Mixed Results   Red for Unsatisfactory

Program Assessment Rating Tool (PART): Like the PMA, the PART process gives the Department of the Treasury a framework for assessing performance in its major programs. Through the use of in-depth performance questions, PART allows the Department leadership to evaluate how well a program is meeting its intended objectives, how effectively and efficiently it is managed, the extent to which the program supports the Department's overarching strategic goals and how well the program achieves results.

The Treasury Department continues to work towards achieving strong PART scores by: (1) improving goals and measures; (2) providing a training session that includes an exchange of lessons learned across bureaus; and (3) solid evidentiary procedures. We estimate that 83 percent of the Department's PART evaluations will score "adequate" or better in FY 2006. Additional details of OMB recommendations and actions planned or underway for each program can be found in the appendix of this report. Scores are still pending for the programs PARTed for the FY 2007 (2008 budget year) and will be reported in the FY 2007 Performance and Accountability Report.

Revision of the Strategic Plan: In FY 2006, the Treasury Department embarked on a total revision of its Strategic Plan. This new plan more clearly defines the strategic priorities and better articulates outcome-oriented goals and objectives. The Department tested its mission, goals and strategies against a set of future possibilities to ensure they are robust. Outcomes that the Department wants to achieve were identified, recognizing that outcomes connect us across different programs and organizations. A new vision statement and a set of core values were added, both of which serve to integrate and draw the Department toward a compelling picture of its future. In addition, this strategic plan establishes the structure by which the Treasury Department will link budget and cost to outcomes, and quantify the value the Department produces for the American people.

Summary of Management Challenges and High Risk Areas:

The Department's Inspectors General and the Government Accountability Office (GAO) have identified the following areas as being the Department's most significant challenges and having high-risk:

- Corporate Management
- Management of Capital Investment
- Information Security
- Linking Resources to Results
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement
- Modernization of the Internal Revenue Service
- Tax Compliance Initiatives
  - Business and Individual
  - Tax-Exempt Entities
- Security of the Internal Revenue Service
- Providing Quality Taxpayer Service Operations
- Complexity of the Tax Law
- Using Performance and Financial Information for Program and Budget Decisions
- Erroneous and Improper Payments
- Taxpayer Protection and Rights
- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Human Capital

Analysis of Financial Statements

The following are the condensed financial statements of the Department as of and for the years ended September 30, 2006 and 2005. The complete financial statements and auditors' report are in Part III of this report.

Condensed Balance Sheets
As of September 30, 2006 and 2005
(In Millions)

	2006	2005
ASSETS		
Intra-governmental Assets		
Due From the General Fund	$ 8,540,195	$ 7,978,081
Other Intra-governmental Assets	326,552	304,677
Total Intra-governmental Assets	**8,866,747**	**8,282,758**
Cash, Foreign Currency, and Other Monetary Assets	63,892	47,578
Investments and Related Interest	9,325	9,404
Tax, Other and Related Interest Receivables, Net	21,962	21,430
Other Assets	26,052	33,202
Total Assets	**$ 8,987,978**	**$ 8,394,372**
LIABILITIES		
Intra-governmental Liabilities		
Federal Debt and Interest Payable	$ 3,673,117	$ 3,354,905
Other Intra-governmental Liabilities	320,817	288,137
Total Intra-governmental Liabilities	**3,993,934**	**3,643,042**
Federal Debt and Interest Payable	4,844,074	4,600,668
Other Liabilities	35,056	35,354
Total Liabilities	**$8,873,064**	**$8,279,064**
NET POSITION		
Unexpended Appropriations	68,270	63,182
Cumulative Results of Operations	46,644	52,126
Total Net Position	**$ 114,914**	**$ 115,308**
Total Liabilities and Net Position	**$ 8,987,978**	**$ 8,394,372**

Condensed Statements of Net Cost
For the Years Ended September 30, 2006 and 2005
(In Millions)

	2006	2005
Cost of Treasury Operations:		
Net Economic Program Cost	$ 1,188	$ 2,284
Net Financial Program Cost	12,413	11,093
Net Management Program Cost	428	417
Total Net Cost of Operations	**$ 14,029**	**$ 13,794**
Net Federal Costs	399,806	351,075
Net Cost of Operations, Federal Debt Interest, and Other Federal Costs	**$ 413,835**	**$ 364,869**

Condensed Statement of Changes in Net Position
For the Years Ended September 30, 2006 and 2005
(In Millions)

	FY 2006				FY 2005
	Combined Earmarked Funds	Combined All Other Funds	Eliminations	Consolidated Total	Consolidated Total
CUMULATIVE RESULTS OF OPERATIONS					
Beginning Balance, as Adjusted	$ 30,817	$ 21,309	$ 0	$ 52,126	$ 56,308
Budgetary Financing Sources	441	412,061	(30)	412,472	362,272
Other Financing Sources	4	(3,653)	(470)	(4,119)	(1,585)
Total Financing Sources	445	408,408	(500)	408,353	360,687
Net Cost of Operations	352	(414,687)	500	(413,835)	(364,869)
Net Change	797	(6,279)	0	(5,482)	(4,182)
Cumulative Results of Operations	**$ 31,614**	**$ 15,030**	**$ 0**	**$ 46,644**	**$ 52,126**
UNEXPENDED APPROPRIATIONS					
Beginning Balance, as Adjusted	202	62,980		63,182	56,850
Total Budgetary Financing Sources	0	5,088		5,088	6,332
Total Unexpended Appropriations	202	68,068		68,270	63,182
Net Position	**$ 31,816**	**$ 83,098**		**$ 114,914**	**$ 115,308**

Condensed Statements of Budgetary Resources
For the Years Ended September 30, 2006 and 2005
(In Millions)

	2006	2005
Budgetary Resources:		
Unobligated Balance, Brought Forward	$ 64,670	$ 69,912
Recoveries of Prior Year Unpaid Obligations	380	1,286
Budget Authority	446,742	386,110
Other Budget Authority	(8,701)	(3,976)
Total Budgetary Resources	**$ 503,091**	**$ 453,332**
Status of Budgetary Resources:		
Obligations Incurred	445,551	388,662
Unobligated Balance	47,093	54,656
Unobligated Balance Not Available	10,447	10,014
Total Status of Budgetary Resources	**$ 503,091**	**$ 453,332**
Change in Obligated Balance		
Total Unpaid Obligated Balances, Net	$ 45,738	$ 41,446
Obligations Incurred, Net	445,551	388,662
Gross Outlays	(438,494)	(383,128)
Recoveries of Prior Year Unpaid Obligations, Actual	(380)	(1,286)
Changes in Uncollected Customer Payments from Federal Sources	33	46
Total Unpaid Obligated Balance, net, End of Period	52,448	45,738
Net Outlays		
Gross Outlays	$ 438,494	$ 383,128
Offsetting Collections and Distributed Offsetting Receipts	(25,467)	(21,907)
Net Outlays	**$ 413,027**	**$ 361,221**

Condensed Statements of Financing
For the Years Ended September 30, 2006, and 2005
(In Millions)

	2006	2005
Resources Used to Finance Activities:		
Net Obligations	$ 419,300	$ 365,515
Net Other Resources Used to Finance Activities	(4,119)	(1,585)
Total Resources Used to Finance Activities	**415,181**	**363,930**
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	2,438	(973)
Total Resources Used to Finance the Net Cost of Operations	**$ 412,743**	**$ 364,903**
Total Components of Net Cost of Operations That Will not Require or Generate Resources in the Current Period	1,092	(34)
Net Cost of Operations	**$ 413,835**	**$ 364,869**

Condensed Statements of Custodial Activity
For the Years Ended September 30, 2006, and 2005
(In Millions)

	2006	2005
Sources of Custodial Revenue:		
Revenue Received		
Individual Income and FICA Taxes	$ 2,034,209	$ 1,864,687
Corporate Income Taxes	380,426	306,869
Other Revenues	146,937	131,911
Total Revenue Received	**2,561,572**	**2,303,467**
Less Refunds	(277,778)	(267,114)
Net Revenue Received	**2,283,794**	**2,036,353**
Accrual Adjustment	554	643
Total Custodial Revenue	**2,284,348**	**2,036,996**
Disposition of Custodial Revenue:		
Amounts Provided to Fund the Federal Government	2,283,420	2,035,899
Other	928	1,097
Total Disposition of Custodial Revenue	**2,284,348**	**2,036,996**
Net Custodial Revenue Activity	**$ 0**	**$ 0**

Auditors' Report on the Treasury Department's Financial Statements

The Department received an unqualified audit opinion on its FY 2006 financial statements. The auditor reported a material weakness and two other reportable conditions.

Limitations on the Principal Financial Statements

These statements have been prepared from Treasury's accounting records in conformity with the accounting principles generally accepted in the United States, and the form and content of entity financial statements specified by OMB Circular A-136, *Financial Reporting Requirements*, as amended. These principles are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is designated the official accounting standards setting body of the Federal government by the American Institute of Certified Public Accountants.

While the financial statements have been prepared from the books and records of the entity, in accordance with the formats prescribed by OMB, they are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

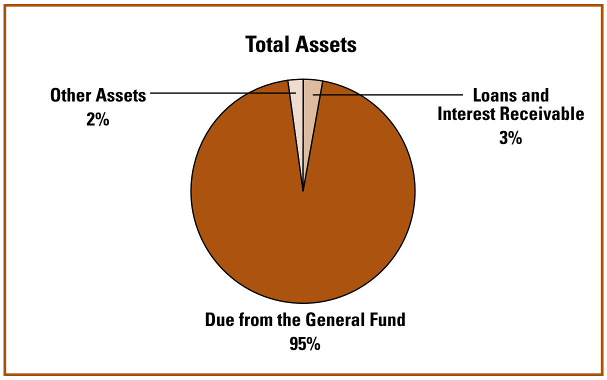
The financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Financial Highlights

The following provides the highlights of Treasury's financial position and results of operations for FY 2006.

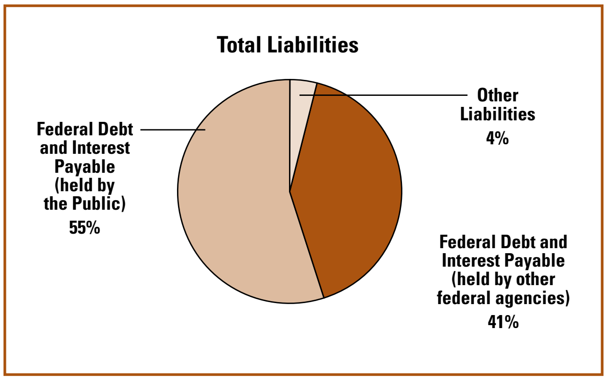
Assets. Total assets increased from $8.4 trillion at September 30, 2005 to $9.0 trillion at September 30, 2006. The primary reason for the increase is the rise in the federal debt, which causes a corresponding rise in the "Due from the General Fund of the U.S. Government" account ($8.5 trillion.) This account represents future funds due from the General Fund of the U.S. Government to pay borrowings from the public and other federal agencies.

The majority of loans and interest receivable ($245.2 billion) included in "Other Intra-governmental Assets" are the loans issued by the Bureau of the Public Debt to other federal agencies for their own use or to private sector borrowers, whose loans are guaranteed by the federal agencies. In addition, $288 million are loans and credits issued by the United States to various foreign governments. These loans are due and payable in U.S. denominations.

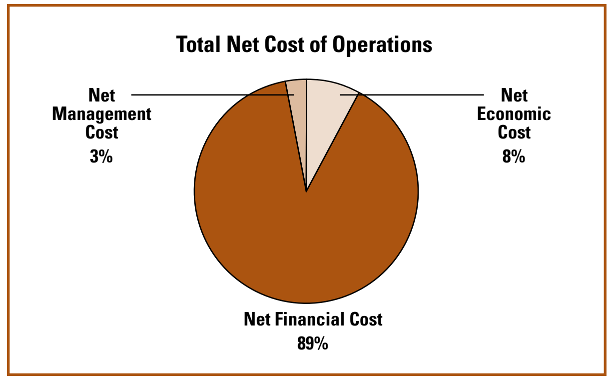


Liabilities. Intra-governmental liabilities totaled $4.0 trillion, and include $3.7 trillion of principal and interest payable to various Federal agencies such as the Social Security Trust Fund. These borrowings do not include debt issued separately by other governmental agencies, such as the Tennessee Valley Authority or the Department of Housing and Urban Development.

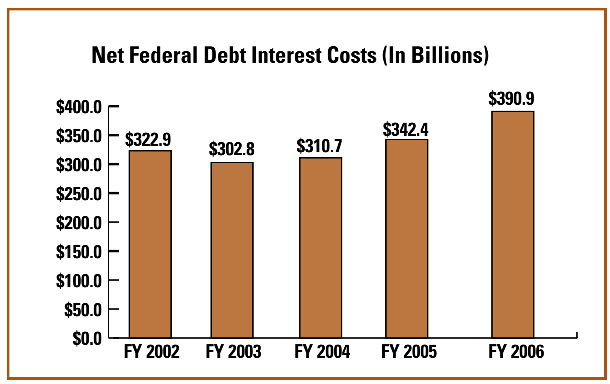
Liabilities also include federal debt held by the public, including interest, of $4.8 trillion; the majority of this debt was issued as Treasury Notes. The increase in total liabilities in FY 2006 over FY 2005 ($594 billion and 7.2%), is the result of increases in borrowings from various federal agencies ($318 billion), and federal debt held by the public, including interest, ($243 billion). Debt held by the public increased primarily because of the need to finance budget deficits.



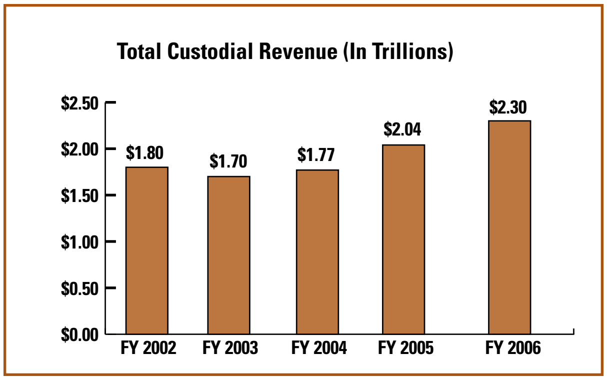
Net Cost of Treasury Operations. The Consolidated Statement of Net Cost presents the Department's gross and net cost for its three strategic missions: economic program, financial program, and management program. The majority of the net cost of Treasury operations is in the financial mission area, which the cost increased in FY 2006 by $1.3 billion. Treasury is the primary fiscal agent for the Federal government in managing the Nation's finances by collecting revenue, making Federal payments, managing Federal borrowing, performing central accounting functions, and producing coins and currency sufficient to meet the demand.

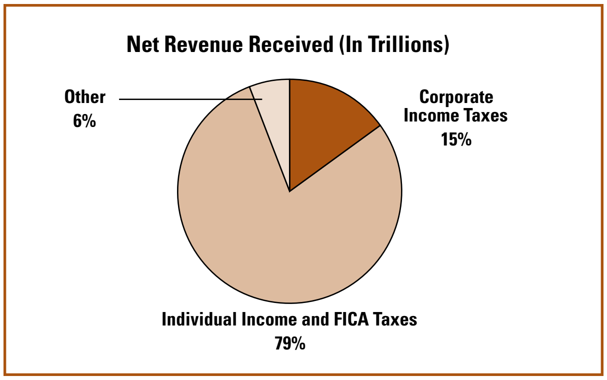


Net Federal Debt Interest Costs. Interest costs have increased significantly ($48.5 billion in FY 2006 and $31.8 billion in FY 2005) over the past two years due to the increase in the federal debt.



Custodial Revenue. Total net revenue collected by Treasury on behalf of the federal government includes various taxes, primarily income taxes, user fees, fines and penalties, and other revenue. Over 93 percent of the revenues are from income and social security taxes. Following a 15% ($260.8 billion) increase in FY 2005, net revenue increased by 12% ($247.4 billion) in FY 2006, due to a continuing high level of economic activity. The majority of increase in revenue was from the individual income and FICA taxes, which was primarily attributed to the growth in wages and overall taxable income.


Total Custodial Revenue (In Trillions)
$2.50
$2.00
$1.50
$1.00
$0.50
$0.00
$1.80
$1.70
$1.77
$2.04
$2.30
FY 2002
FY 2003
FY 2004
FY 2005
FY 2006


Net Revenue Received (In Trillions)
Other
6%
Corporate
Income Taxes
15%
Individual Income and FICA Taxes
79%

Improper Payments Information Act and Recovery Act

Summary of FY 2006 Activities

Improper Payments Information Act

Background

The Improper Payments Information Act of 2002 (IPIA) requires agencies to review their programs and activities annually to identify those that are susceptible to significant erroneous payments. According to OMB Circular A-123, Appendix C, "Management's Responsibility for Internal Controls", "Significant" means that an estimated error rate and a dollar amount exceed the threshold of 2.5% and $10 million of total program funding. OMB Circular A-123, Appendix C also requires the agency to implement a corrective action plan that includes improper payment reduction and recovery targets.

Some Federal programs are so complex that developing an annual error rate is not feasible. The government-wide Chief Financial Officers Council developed an alternative for such programs to assist them in meeting the IPIA requirements. Agencies may establish an annual estimate for a high-risk component of a complex program (e.g., a specific program population) with the Office of Management and Budget (OMB) approval. Agencies also must perform trend analyses to update the program's baseline error rate in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

Treasury's Risk Assessment Methodology and Results for FY 2006

Each year, the Department develops a comprehensive inventory of all funding sources and conducts a risk assessment for improper payments on all of its programs and activities. The risk assessment performed on all of Treasury's programs and activities resulted in low and medium risk susceptibility for improper payments except for the Internal Revenue Service's (IRS) Earned Income Tax Credit (EITC) program. The high-risk status of this program is well-documented and has been deemed a complex program for the purposes of the Improper Payments Information Act.

Earned Income Tax Credit

The Earned Income Tax Credit is a refundable tax credit that offsets income tax owed by low-income taxpayers and, if the credit exceeds the amount of taxes due, provides a lump-sum payment in the form of a refund to those who qualify. The FY 2006 estimate is that a maximum of 28% ($11.6 billion) and a minimum of 23% ($9.8 billion) of the EITC total program payments are overclaims.

Since June 2003, IRS has focused on reducing EITC overclaims through a five-point initiative designed to:

- Reduce the backlog of pending EITC examinations
- Minimize the burden and enhance the quality of communications with taxpayers
- Encourage eligible taxpayers to claim the EITC
- Ensure fairness by refocusing compliance efforts on income-ineligible taxpayers
- Pilot a certification effort to substantiate qualifying child residency eligibility

The Department continues to work with OMB to establish viable error rate measurements while working toward the development of a Corrective Action Plan.

Recovery Audit Act

Background

The Recovery Audit Act requires agencies issuing in excess of $500 million in contracts to establish and maintain recovery auditing activities and report on the results of those recovery efforts annually. Recovery auditing activities include the use of (1) contract audits, in which an examination of contracts pursuant to the audit and records clause incorporated in the contract is performed, (2) contingency contracts for recovery services in which the contractor is paid a percentage of the recoveries, and (3) internal review and analysis in which payment controls are employed to ensure that contract payments are accurate.

Results for FY 2006

During FY 2006, $4.6 billion in contracts (defined as issued and obligated contracts, modifications, task orders, and delivery orders) were issued. Improper payments in the amount of $2,305,424 were identified from recovery auditing efforts and, of this amount, $1,442,708 has been recovered with $862,716 outstanding as accounts receivable on September 30, 2006.

Management Assurances

The Secretary's Letter of Assurance

Management is responsible for establishing and maintaining internal controls, and the Department has evaluated its management controls, internal controls over financial reporting, and compliance with Federal financial systems standards. As part of the Department's evaluation process, the results of extensive testing, assessment, and independent audits were considered.

The Department can provide reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act have been achieved, as a result of our evaluations, except for the material weaknesses noted below. We can provide qualified assurance that internal controls over financial reporting are effective as of June 30, 2006. Our assessment was conducted in accordance with the Office of Management and Budget Circular A-123, Appendix A. The Department is not in substantial compliance with the Federal Financial Management Improvement Act, however, because of its material weaknesses involving revenue accounting systems. The revenue accounting system weakness is the only weakness that affected our overall assurance level for A-123, Appendix A, for internal controls over financial reporting.

The Department retains six remaining material weaknesses as of September 30, 2006. The weaknesses are in the following areas:

Internal Revenue Service

- Resolving weaknesses in revenue accounting systems
- Improving systems modernization management and controls
- Reducing overclaims in the Earned Income Tax Credit program
- Improving systems security controls

Financial Management Service

- Improving systems, controls, and procedures to prepare the Government-wide financial statements

Departmental Offices

- Improving systems security

The Department began the year with seven material weaknesses. During FY 2006 no new material weaknesses were identified and one weakness was closed. Detailed information on our material weaknesses is provided in Appendix E. We continually are achieving positive results through:

- Emphasizing internal control program responsibilities throughout the Department.
- Ensuring senior management attention to management controls.
- Developing and implementing capital planning investment control processes.
- Focusing on developing and carrying out responsible plans for resolving weaknesses.

The progress we have achieved over the past few years will continue in FY 2007.

Sincerely,

Henry M. Paulson, Jr.

Material Weaknesses, Audit Follow-up, and Financial Systems

Federal Managers' Financial Integrity Act (FMFIA)

The management control objectives under FMFIA are to reasonably ensure that:

- programs achieve their intended results.
- resources are used consistent with overall mission.
- programs and resources are free from waste, fraud and mismanagement.
- laws and regulations are followed.
- controls are sufficient to minimize any improper or erroneous payments.
- performance information is reliable.
- system security is in substantial compliance with all relevant requirements.
- continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels.
- financial management systems are in compliance with Federal financial systems standards.

Deficiencies that seriously affect an agency's ability to meet these objectives are deemed "material weaknesses." The Department can provide reasonable assurance that the objectives of FMFIA have been achieved, except for the remaining material weaknesses noted in the Secretary's Letter of Assurance above. During FY 2006, the Department had a decrease of one material weakness. The reduction came as a result of the downgrade of the IRS material weakness "Collection of Unpaid Taxes" to a reportable condition. Six material weaknesses are outstanding as of September 30, 2006. Four of the remaining six are complex systems development or systems security weaknesses, and will require a more protracted timeframe to resolve. The last currently identified material weakness is targeted to be closed in FY 2009. See Appendix E for additional information on FMFIA material weaknesses.

Material weaknesses, both the resolution of existing ones and the prevention of new ones, received special attention during FY 2006. Over the past five years, we have made great progress in reducing the number of material weaknesses Treasury-wide. For FY 2007, we have made material weakness resolution a performance requirement for every executive, manager, and supervisor to continue our path of resolving the current material weaknesses and preventing new ones before they occur.

Office of Management and Budget Circular A-123, Appendix A

The Department continues to strengthen and improve the execution of our mission through the application of sound internal controls over financial reporting. In response to Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Controls*, Appendix A, the Department developed and implemented an extensive testing and assessment methodology that identified and documented internal controls over financial reporting at the transaction level integrated with the Government Accountability Office's Standards for Internal Control. The testing and assessment was completed across all material Department bureaus and offices by June 30, 2006. The Department provides qualified reasonable assurance that internal controls over financial reporting are effective as of June 30, 2006 due to the revenue accounting system weaknesses at the Internal Revenue Service.

Federal Financial Management Improvement Act (FFMIA)

FFMIA mandates that agencies "... implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level." FFMIA also requires that remediation plans be developed for any entity that is unable to report substantial compliance with these requirements.

As of September 30, 2006, the Department is not in substantial compliance with these requirements due to the revenue accounting system weaknesses at the

Internal Revenue Service. The Department continues to make progress with the implementation of the IRS remediation plan. For additional information on FFMIA non-compliance, see Appendix E.

Audit Follow-Up

During FY 2006, Treasury continued its efforts to improve both the general administration of management control issues throughout the Department and the timeliness of the resolution of all findings and recommendations identified by the Office of the Inspector General (OIG), the Treasury Inspector General for Tax Administration (TIGTA), the Government Accountability Office, and external auditors.

The Department management at every level will maintain the momentum on accomplishing Planned Corrective Actions (PCAs) to resolve and implement sound solutions for all audit recommendations, and, although we have made great progress, we have considerably more work to do. Specifically, we must provide timely and accurate performance in addressing PCA schedules and implementation and integrate the effects of those actions more fully into our management decision-making processes. We need to identify more precisely what it costs to accomplish our varied missions and develop ways to improve overall performance. This will entail building upon the progress we have made in expanding the communication and coordination among offices variously involved in strategic planning, budget formulation, budget execution, performance management and financial management.

Financial Management Systems Framework

The Department's overall financial management systems framework consists of a Treasury-wide financial data warehouse, supported by a financial reporting tool and separate bureau financial systems. Bureaus submit monthly financial data to the data warehouse within three business days. The Department produces monthly financial statements and reports for financial analysis. This framework satisfies both the bureaus' diverse financial operational and reporting needs as well as the Department's internal and external reporting requirements. The financial data warehouse is part of the overarching Treasury-wide Financial Analysis and Reporting System (FARS), which also includes applications for bureaus to report the status of their performance measures and the status of their planned audit corrective actions. Additional FARS applications are being planned to improve the Department's financial management and operations. This includes asset management, budget formulation and execution, and enhanced reporting functionality.

The Department continues to enhance its financial management systems. As of September 30, 2006, the number of financial management systems increased to 69, up from 68 at the end of fiscal year 2005.

The Bureau of Public Debt's Administrative Resource Center (ARC) has been selected by the Office of Management and Budget as a Financial Management Line of Business Shared Service Provider. ARC currently services 28 Federal entities for core financial systems, including eleven Treasury bureaus and reporting entities. Over the next two years, two additional Treasury bureaus will migrate to ARC for core financial systems support.

ARC also provides systems and service support to eleven Department bureaus in the processing of their travel needs as part of the Department's e-Travel initiative. Of the three remaining bureaus, one is currently conducting a pilot review. The two remaining bureaus are working with the Department to finalize plans for e-Travel implementation.

The Department's FARS applications are also used to support other Federal agencies. The Department currently hosts two agencies for consolidated financial processing and reporting. In addition, the Department has demonstrated various FARS applications to other agencies to operate within their own computer centers. The Department continues to demonstrate FARS applications to other agencies as requested.