Notes to the Principal Financial Statements

Note 1. Summary of Significant Accounting Policies

Reporting Entity

The U.S. Department of Education (the Department), a Cabinet-level agency of the Executive Branch of the U.S. Government, was established by the Congress on May 4, 1980, under the *Department of Education Organization Act of 1979* (Public Law 96-88). It is responsible, through the execution of its congressionally approved budget, for administering direct loans, guaranteed loans, and grant programs.

The Department administers the William D. Ford Federal Direct Student Loan (Direct Loan) Program, the Federal Family Education Loan (FFEL) Program, the Federal Pell Grant (Pell Grant) Program and the campus-based student aid programs to help students finance the costs of higher education. The Direct Loan Program, authorized by the *Student Loan Reform Act of 1993,* enables the Department to make loans directly to eligible undergraduate and graduate students and their parents through participating schools. The FFEL Program, initially authorized by the *Higher Education Act of 1965*, as amended (HEA), cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students. Under these programs, the loans are made to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public or private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents, based on eligibility criteria, receive loans regardless of income or credit rating. Student borrowers who demonstrate financial need also receive federal interest subsidies.

Additionally, the Department administers numerous grant programs and the facilities loan programs. Grant programs include grants to state and local entities for elementary and secondary education; special education and rehabilitative services; educational research and improvement; and grants for needs of the disadvantaged. Through the facilities loan programs, the Department administers low-interest loans to institutions of higher learning for the construction and renovation of facilities.

The Department is organized into 10 reporting organizations that administer the loan and grant programs. The financial reporting structure of the Department presents operations based on four major reporting groups. The reporting organizations and the major reporting groups are shown below.

Reporting Organizations

- Federal Student Aid (FSA)
- Office of Elementary and Secondary Education (OESE)
- Office of Special Education and Rehabilitative Services (OSERS)
- Office of Vocational and Adult Education (OVAE)
- Office of Postsecondary Education (OPE)
- Institute of Education Sciences (IES)
- Office of English Language Acquisition (OELA)
- Office of Safe and Drug-Free Schools (OSDFS)
- Office of Innovation and Improvement (OII)
- Department Management (DM)

Major Reporting Groups

- Federal Student Aid
- Office of Elementary and Secondary Education
- Office of Special Education and Rehabilitative Services
- Other

The Other major reporting group includes the OVAE, OPE, IES, OELA, OSDFS, OII and DM reporting organizations and Hurricane Education Recovery activities. (See Notes 9 and 11)

Basis of Accounting and Presentation

These consolidated financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, and financing of the U.S. Department of Education, as required by the *Chief Financial Officers Act of 1990* and the *Government Management Reform Act of 1994*. The financial statements were prepared from the books and records of the Department, in accordance with accounting principles generally accepted in the United States of America for federal entities issued by the Federal Accounting Standards Advisory Board (FASAB) and the Office of Management and Budget (OMB) Circular No. A-136, revised as of July 24, 2006, *Financial Reporting Requirements*. These financial statements are different from the financial reports prepared by the Department pursuant to the OMB directives that are used to monitor and control the Department's use of budgetary resources.

The Department's financial statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation providing resources and legal authority to do so.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

Use of Estimates

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

The *Federal Credit Reform Act of 1990* (Credit Reform Act) underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as "subsidy cost." Under the Credit Reform Act, subsidy costs for loans obligated beginning in fiscal year (FY) 1992 are estimated at the net present value of projected lifetime costs in the year the loan is obligated. Subsidy costs are then revalued annually through the re-estimate process.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these components may create significant changes to the estimate.

The Department estimates all future cash flows associated with the Direct Loan and FFEL programs. Projected cash flows are used to develop subsidy estimates. Subsidy cost can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy cost is recorded as the initial amount of the loan guarantee liability when guarantees are made (the loan liability) and as a valuation allowance to government-owned loans and interest receivable (i.e., direct and defaulted guaranteed loans).

The Department uses a computerized cash flow projection Student Loan Model to calculate subsidy estimates for the Direct Loan and FFEL programs. In fiscal year 2006, the Department refined its approach to calculating the subsidy estimates with the input of interest rates derived from a probabilistic technique. This probabilistic technique to forecast interest rates relies on different methods to establish the relationship between an event's occurrence and the magnitude of its probability. The Department's approach estimates interest rates under numerous scenarios and then bases interest rates on the average interest rates weighted by the assumed probability of each scenario occurring. This refinement was undertaken to model certain unique characteristics of the Department's loan programs.

The estimating methods are updated periodically to reflect changing conditions. For each program, cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan's cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for profit) schools.

Estimates reflected in these statements were prepared using assumptions developed for the FY 2007 Mid-Session Review, a government-wide exercise required annually by the OMB. Assumptions and their impact are updated after the Mid-Session Review to account for significant subsequent changes in activity. These estimates are based on the most current information available to the Department at the time the financial statements are prepared. Department management has a process to review these estimates in the context of subsequent changes in activity and assumptions, and to reflect the impact of these changes as appropriate.

The Department recognizes that the cash flow projections and the sensitivity of the changes in assumptions can have a significant impact on the estimates. Management has attempted to mitigate fluctuations in the estimate by using trend analysis to project future cash flows. Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a minimal change in the projected long-term interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount. (See Note 5)

Budget Authority

Budget authority is the authorization provided by law for the Department to incur financial obligations that will result in outlays. The Department's budgetary resources include (1) unobligated balances of resources from prior years, (2) recoveries of obligations in prior years, and (3) new resources—appropriations, authority to borrow from the U.S. Department of Treasury (Treasury), and spending authority from collections.

Unobligated balances associated with resources expiring at the end of the fiscal year remain available for five years after expiration only for upward adjustments of prior year obligations, after which they are canceled and may not be used. Unobligated balances of resources that have not expired at year-end may have new obligations placed against them, as well as net upward adjustments of prior year obligations.

Authority to borrow from Treasury provides most of the funding for the loan principal disbursements made under the Direct Loan Program. Subsidy and administrative costs of the program are funded by appropriations. Budgetary resources from collections are used primarily to repay the Department's debt to Treasury. Major sources of collections include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related fees, and (3) interest from Treasury on balances in certain credit program accounts that make and administer loans and guarantees.

Fund Balance with Treasury

The Fund Balance with Treasury includes appropriated, revolving, and trust funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for the Department. The Department's records are reconciled with those of Treasury.

A portion of the appropriated funds are funded in advance by multi-year appropriations for expenditures anticipated during the current and future fiscal years. Revolving funds conduct continuing cycles of business-like activity and do not require annual appropriations. Their fund balance is derived from borrowings, public collections and other federal agencies. Other funds, which are non-budgetary, primarily consist of deposit funds, and suspense and clearing accounts.

Available unobligated balances represent amounts that are apportioned for obligation in the current fiscal year. Unavailable unobligated balances represent amounts that are not apportioned for obligation during the current fiscal year and expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include receivables for reimbursements earned, unfilled customer orders, undelivered orders and unpaid expended authority. (See Note 2)

Accounts Receivable

Accounts receivable are amounts due to the Department from the public and other federal agencies. Receivables from the public result from recipients of grants and other financial assistance programs, and disputed costs resulting from audits of educational assistance programs. Amounts due from other federal agencies result from reimbursable agreements entered into by the Department with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts. The estimate of the allowance for loss on uncollectible accounts is based on Department experience in the collection of receivables and an analysis of the outstanding balances. (See Note 3)

Cash and Other Monetary Assets

Cash and Other Monetary Assets consist of Guaranty Agency reserves that represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 4) and are offset by a corresponding liability due to Treasury. Guaranty Agency reserves include initial federal start-up funds, receipts of federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income, administrative cost allowances, and other assets.

Section 422A of the HEA required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the "Federal Fund") and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with federal funds, are the property of the United States and reflected in the *Budget of the United States Government*. However, such ownership by the federal government is independent of the actual control of the assets. The net value of the Federal Fund will change from year to year. Recalls are payments to the Department from Guaranty Agency Federal Funds, which increase Fund Balance with Treasury, and will be remitted to Treasury by the end of the fiscal year.

The Department disburses funds to the Guaranty Agency through the Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (as authorized under Section 422A of the HEA). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

Credit Program Receivables and Liabilities for Loan Guarantees

The financial statements reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Credit Reform Act. Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy." The difference is the present value of the cash flows to and from the Department that are expected from the receivables over their projected lives. Similarly, liabilities for loan guarantees are valued at the present value of the cash outflows from the Department less the present value of related inflows. The estimated present value of net long-term cash outflows of the Department for subsidized costs (primarily defaults) is net of recoveries, interest supplements, and offsetting fees. The Department records all credit program loans and loan guarantees at their present values.

Components of subsidy costs for loans and guarantees include defaults (net of recoveries), contractual payments to third-party private loan collectors who receive a set percentage of amounts they collect, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department on its borrowings from Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third-party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are re-estimated each year. (See Note 5)

Other Intragovernmental Assets

Other intragovernmental assets represent advance payment for interagency agreements between the Department and the National Science Foundation. These advance payments are recognized as an asset, which is reduced when actual expenditures are recorded by the Department.

General Property, Plant and Equipment

The Department capitalizes single items of property and equipment with a cost of $50,000 or more that have an estimated useful life greater than two years. Additionally, the Department capitalizes bulk purchases of property and equipment with an aggregate cost of $500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. (See Note 6) Internal Use Software (IUS) meeting the above cost and useful life criteria is also capitalized. IUS is either purchased off the shelf, internally developed, or contractor developed solely to meet the agency's internal needs.

The Department adopted the following useful lives for the major classes of depreciable property and equipment:

Major Classes of Depreciable Property and Equipment	Years
Information Technology (IT), Internal Use Software (IUS) and Telecommunications Equipment	3
Furniture and Fixtures	5

Liabilities

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by the Department without an appropriation or other collection of revenue for services provided. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, and there is no certainty the appropriation will be enacted. The government acting in its sovereign capacity can abrogate liabilities that arise from activities other than contracts. FFEL Program and Direct Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

Debt

The Department borrows to provide funding for direct loans to students and facilities loans. The liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with the Department's student loan activities. The Department repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury, with such rates generally fixed based on the rate for 10-year securities. As discussed in Note 5, the interest received by the Department from borrowers will vary from the rate paid to the Treasury. Principal and interest payments to the Treasury are made annually.

In addition, the Federal Financing Bank (FFB) holds bonds issued by the Department on behalf of the Historically Black Colleges and Universities Capital Financing Program. The Department reports the corresponding liability for full payment of principal and accrued interest as a payable to the FFB. (See Note 7)

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by the Department for expenditures incurred by grantees prior to their receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 9)

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except for federal credit financing and liquidating funds, and trust funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 10)

Earmarked Funds

Earmarked funds are recorded as specially identified revenues, often supplemented by other financing sources, which remain available over time. These funds are required by statute to be used for designated activities, benefits or purposes. The Department's earmarked funds are primarily related to the 2005 Hurricane Relief efforts. (See Note 15)

Personnel Compensation and Other Employee Benefits

Annual, Sick and Other Leave. The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans and Other Retirement Benefits. Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay.

FERS consists of Social Security, a basic annuity plan, and the Thrift Savings Plan. The Department and the employee contribute to Social Security and the basic annuity plan at rates prescribed by law. In addition, the Department is required to contribute to the Thrift Savings Plan a minimum of 1 percent per year of the basic pay of employees covered by this system and to match voluntary employee contributions up to 3 percent of the employee's basic pay, and one-half of contributions between 3 percent and 5 percent of basic pay. For FERS employees, the Department also contributes the employer's share of Medicare.

Contributions for CSRS, FERS and other retirement benefits are insufficient to fully fund the programs, which are subsidized by the Office of Personnel Management (OPM). The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees.

Federal Employees' Compensation Act. The *Federal Employees' Compensation Act* (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA Program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two- to three-year time period between payment by Labor and reimbursement by the Department. As a result, a liability is recognized for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using the OMB economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost-of-living adjustments), and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

The estimated projections are evaluated by Labor to ensure the resulting projections are reliable. The analysis is based on four tests: (1) a sensitivity analysis of the model to economic assumptions, (2) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in charge back year 2006 to the average pattern observed during the most current three charge back years, and (4) a comparison of the estimated liability per case in the 2006 projection to the average pattern for the projections of the most recent three years.

Intragovernmental Transactions

The Department's financial activities interact with and are dependent upon the financial activity of the centralized management functions of the federal government. Due to financial regulation and management control by the OMB and Treasury, operations may not be conducted and financial positions may not be reported as they would if the Department were a separate, unrelated entity. Transactions and balances among the Department's entities have been eliminated from the Consolidated Balance Sheet.

Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

Note 2. Fund Balance with Treasury

(Dollars in Millions)	2006	2005
Appropriated Funds	$ 54,790	$ 49,455
Revolving Funds	52,176	28,104
Trust Funds	61	-
Other Funds	26	10
Fund Balance with Treasury	**$ 107,053**	**$ 77,569**

Status of Fund Balance with Treasury

(Dollars in Millions)	2006	2005
Unobligated Balance		
Available	$ 4,081	$ 526
Unavailable	47,063	23,540
Obligated Balance, Not Yet Disbursed	55,883	53,493
Non-Budgetary FBWT	26	10
Status of Fund Balance with Treasury	**$ 107,053**	**$ 77,569**

Note 3. Accounts Receivable

	2006		
(Dollars in Millions)	Gross Receivables	Allowance	Net Receivables
Intragovernmental	$ 1	$ -	$ 1
With the Public	232	(189)	43
Accounts Receivable	**$ 233**	**$ (189)**	**$ 44**

	2005		
(Dollars in Millions)	Gross Receivables	Allowance	Net Receivables
Intragovernmental	$ -	$ -	$ -
With the Public	318	(177)	141
Accounts Receivable	**$ 318**	**$ (177)**	**$ 141**

Note 4. Cash and Other Monetary Assets

(Dollars in Millions)	2006	2005
Beginning Balance, Cash and Other Monetary Assets	**$ 888**	**$ 1,040**
Downward Valuation of Guaranty Agency Federal Funds	(29)	(152)
Recalls from Guaranty Agency Federal Funds		
Remitted to Treasury as of September 30	(280)	-
Payable to Treasury as of September 30	(13)	-
Total Recalls	(293)	-
Ending Balance, Cash and Other Monetary Assets	**$ 566**	**$ 888**

Cash and Other Monetary Assets consist of Guaranty Agency reserves and represent non-entity assets.

Note 5. Credit Programs for Higher Education

The federal government makes loans directly to students and parents through participating schools under the Direct Loan Program. In addition, loans are originated and serviced through contracts with private vendors.

Private lender loans to students and parents are insured by the federal government under the FFEL Program. FFEL loans are guaranteed by the federal government against default with state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees.

Beginning with FFEL loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default. Guaranty Agencies also began paying a portion of the cost (in most cases, 5 percent) of each defaulted loan from federal reserves they hold in trust. (See Note 4) FFEL lender participants receive statutorily set federal interest and special allowance subsidies. Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and loan cancellations. The same methodology is used to estimate the allowance on Direct Loan receivables.

The Department disbursed approximately $32.3 billion in direct loans to eligible borrowers in fiscal year 2006 and approximately $27.5 billion in fiscal year 2005. Loans typically are disbursed in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Half of all loan volume is obligated in the fourth quarter of the fiscal year. Regardless of the fiscal year in which they occur, disbursements are tracked by cohort as determined by the date of obligation rather than disbursement.

As of September 30, 2006 and 2005, total principal balances outstanding of guaranteed loans held by lenders were approximately $325 billion and $289 billion, respectively. As of September 30, 2006 and 2005, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately $321 billion and $288 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their Federal Fund. Payments by Guaranty Agencies do not reduce government exposure because they are made from the Federal Fund administered by the agencies but owned by the federal government.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection, and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection. Accrued interest on the subrogated loan is calculated but only realized upon collection.

Due to the nature of the loan commitment process in which schools establish a loan commitment with the filing of an aid application, which may occur before a student has been accepted by the school or begins classes, approximately 7 percent of loan commitments are never disbursed. For direct loans committed in fiscal year 2006, an estimated $1.2 billion will not be disbursed; for guaranteed loans committed in fiscal year 2006, an estimated $7.6 billion will not be disbursed. Direct loan schools may originate loans through a cash advance from the Department, establishing a loan receivable, or by advancing their own funds in anticipation of reimbursement from the Department.

Loan Consolidations

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. The Department permits borrowers to prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan.

Under the Credit Reform Act and requirements provided by OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, the retirement of loans being consolidated is considered a receipt of principal and interest; this receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or nonperforming, in any given cohort are paid off in their original cohort, and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in establishing the subsidy rate for defaults. The effect of new consolidations is reflected in subsidy expense for the current year cohort, while the effect on prior cohorts is reflected in the re-estimate. The loan liability and net receivables include estimates of future prepayments of existing loans through consolidations; they do not reflect costs associated with anticipated future consolidation loans.

Variable student loan interest rates were reset on July 1, 2006, increasing nearly two percentage points from 5.30 percent for academic year 2005–06 to 7.14 percent for academic year 2006–07. In fiscal year 2005, rates were reset on July 1, 2005, from 3.37 percent for academic year 2004–05 to 5.30 percent for academic year 2005–06. In anticipation of these increases in both years, private lenders, schools, and others encouraged borrowers to consolidate their existing variable rate loans into fixed rate loans. This dramatic change in interest rates resulted in surges in loan consolidations. Direct loan consolidation disbursements for fiscal year 2006 were $19.9 billion and $15.3 billion for fiscal year 2005.

Based on current estimates, the prepayment of the underlying FFEL loans produces significant savings through the elimination of future special allowance payments. New consolidations are reflected in the 2006 cohort resulting in increased prepayments of underlying loans from prior cohorts.

Credit Program Receivables, Net

(Dollars in Millions)	2006	2005
Direct Loan Program Loan Receivables, Net	$ 92,603	$ 95,696
FFEL Program Loan Receivables, Net	13,588	11,712
Perkins Program Loan Receivables, Net	192	194
Facilities and Other Loan Receivables, Net	345	335
Credit Program Receivables, Net	**$ 106,728**	**$ 107,937**

The following schedules summarize the Direct Loan and defaulted FFEL principal and related interest receivable, net or inclusive of the allowance for subsidy.

Direct Loan Program Receivables

(Dollars in Millions)	2006	2005
Principal Receivable	$ 97,306	$ 94,707
Interest Receivable	3,702	3,121
Receivables	**101,008**	**97,828**
Less: Allowance for Subsidy	8,405	2,132
Credit Program Receivables, Net	**$ 92,603**	**$ 95,696**

Of the $101.0 billion in Direct Loan receivables as of September 30, 2006, $8.1 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2005, $7.2 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group out of a total receivable of $97.8 billion.

FFEL Program Receivables

	2006			2005		
(Dollars in Millions)	Pre-1992	Post-1991	Total	Pre-1992	Post-1991	Total
Principal Receivable	$ 8,730	$ 10,263	$ 18,993	$ 9,306	$ 8,567	$ 17,873
Interest Receivable	336	1,823	2,159	595	1,691	2,286
Receivables	**9,066**	**12,086**	**21,152**	**9,901**	**10,258**	**20,159**
Less: Allowance for Subsidy	4,717	2,847	7,564	6,736	1,711	8,447
Credit Program Receivables, Net	**$ 4,349**	**$ 9,239**	**$ 13,588**	**$ 3,165**	**$ 8,547**	**$ 11,712**

Loan Modifications

According to OMB Circular No. A-11, any government action that differs from actions assumed in the baseline estimate of cash flows and changes the estimated cost of an outstanding direct loan or loan guarantee is defined as a modification. Over the past two fiscal years, the Department has executed separate loan modifications. These modifications were the result of legislation that altered the estimated cost of outstanding direct loans or loan guarantees.

Each modification is separate and distinct. However, each is recognized under the same accounting principle for upward or downward adjustments to subsidy cost and for the recordation of modification adjustment transfer gains or losses.

Separate amounts are calculated for modification costs and modification adjustment transfers. Modification adjustment transfers are required to adjust for the difference between current discount rates used to calculate modification costs and the discount rates used to calculate cohort interest expense and revenue.

2006 Modification

The *Deficit Reduction Act of 2005* (P.L. 109-171) (Deficit Reduction Act) included provisions revising the payment of account maintenance fees, Guaranty Agency retention on default collections, and an expansion of deferment eligibility for military borrowers performing eligible service. The Deficit Reduction Act shifts the payment of account maintenance fees, authorized under Section 458 of the HEA, to subsidy cost from administration funds or from the Federal Fund.

Beginning October 1, 2006, the Deficit Reduction Act requires Guaranty Agencies to return to the Department a portion of collection charges on defaulted loans paid off through consolidation equal to 8.5 percent of the outstanding principal and interest. Beginning October 1, 2009, Guaranty Agencies will be required to return the entire 18.5 percent on collections through consolidation that exceed 45 percent of their overall collections. In addition, the new military deferment provisions provide a maximum three-year deferment for soldiers serving in a war zone who have outstanding loans originated after July 1, 2001.

The FFEL Program recognized $1.7 billion and the Direct Loan Program recognized $7 million in modification costs in fiscal year 2006. The FFEL Program also recognized a net modification adjustment transfer gain of $94 million, while the Direct Loan Program recognized a net gain of $134 thousand.

2005 Modification

The *Taxpayer-Teacher Protection Act of 2004* (P.L. 108-409) increased the maximum amount of loan cancellation from $5,000 to $17,500 at the end of the fifth year of teaching for certain teachers who were new student loan borrowers between October 1, 1998 and October 1, 2005.

The FFEL Program recognized $148 million and the Direct Loan Program recognized $49 million in modification costs in fiscal year 2005. The FFEL Program also recognized a net modification adjustment transfer gain of $3 million, while the Direct Loan Program recognized a net gain of $1 million.

Direct Loan Program Reconciliation of Allowance for Subsidy

(Dollars in Millions)	2006	2005
Beginning Balance, Allowance for Subsidy	**$ 2,132**	**$ (1,644)**
Components of Subsidy Transfers		
Interest Rate Differential	(601)	(238)
Defaults, Net of Recoveries	1,226	355
Fees	(403)	(401)
Other	1,566	1,286
Current Year Subsidy Transfers	**1,788**	**1,002**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates[1]	(339)	1,703
Technical and Default Re-estimates	5,199	2,457
Subsidy Re-estimates	**4,860**	**4,160**
Components of Loan Modifications		
Loan Modification Costs	7	49
Modification Adjustment Transfers	-	(1)
Loan Modifications	**7**	**48**
Activity		
Fee Collections	473	461
Loan Cancellations[2]	(100)	(110)
Subsidy Allowance Amortization	(406)	(1,454)
Other	(349)	(331)
Total Activity	**(382)**	**(1,434)**
Ending Balance, Allowance for Subsidy	**$ 8,405**	**$ 2,132**

[1] The interest rate re-estimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury.
[2] Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

Direct Loan Financing Account Interest Expense and Interest Revenue

(Dollars in Millions)	2006	2005
Interest Expense on Treasury Borrowing	$ 6,505	$ 6,171
Interest Expense	**$ 6,505**	**$ 6,171**
Interest Revenue from the Public	$ 4,173	$ 3,242
Amortization of Subsidy	406	1,454
Interest Revenue on Uninvested Funds	1,926	1,475
Interest Revenue	**$ 6,505**	**$ 6,171**

The Direct Loan Financing Account borrows from Treasury to fund the unsubsidized portion of its lending activities. As required, the Department calculates and pays Treasury interest at the end of each year. Interest is earned on the outstanding Direct Loan portfolio during the year and on its weighted average Fund Balance with Treasury at year-end.

Subsidy amortization is calculated, as required in Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*, as the difference between interest revenue and interest expense. The allowance for subsidy is adjusted with the offset to interest revenue.

Payable to Treasury

(Dollars in Millions)	2006	2005
Future Liquidating Account Collections, Beginning Balance	$ 3,411	$ 3,491
Valuation of Pre-1992 Loan Liability and Allowance	2,036	851
Capital Transfers to Treasury	(892)	(931)
Future Liquidating Account Collections, Ending Balance	**4,555**	**3,411**
Collections on Guaranty Agency Federal Funds	13	-
FFEL Downward Subsidy Re-estimate	951	1,755
Payable to Treasury	**$ 5,519**	**$ 5,166**

The liquidating account, based on available fund balance each year, liquidates the Fund Balance with Treasury. The FFEL financing account pays the liability related to downward subsidy re-estimates upon budget execution.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

(Dollars in Millions)	2006	2005
Beginning Balance, Liability for Loan Guarantees	**$ 30,500**	**$ 23,214**
Components of Subsidy Transfers		
Interest Supplement Costs	18,268	12,562
Defaults, Net of Recoveries	1,665	865
Fees	(7,859)	(5,554)
Other[1]	4,264	2,500
Current Year Subsidy Transfers	**16,338**	**10,373**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	90	(72)
Technical and Default Re-estimates	9,924	(586)
Subsidy Re-estimates	**10,014**	**(658)**
Components of Loan Modifications		
Loan Modification Costs	1,710	148
Modification Adjustment Transfers	94	(3)
Loan Modifications	**1,804**	**145**
Activity		
Interest Supplement Payments	(8,925)	(5,077)
Claim Payments	(4,345)	(3,716)
Fee Collections	3,799	3,060
Interest on Liability Balance	1,110	565
Other[2]	2,055	2,594
Total Activity	**(6,306)**	**(2,574)**
Ending Balance, Liability for Loan Guarantees	**52,350**	**30,500**
FFEL Liquidating Account Liability for Loan Guarantees	103	111
Liabilities for Loan Guarantees	**$ 52,453**	**$ 30,611**

[1] Subsidy primarily associated with debt collections and loan cancellations due to death, disability, and bankruptcy.
[2] Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

The FFEL liquidating account liability for loan guarantees is included in the total Liabilities for Loan Guarantees as shown in the FFEL Program Reconciliation of Liabilities.

Subsidy Expense

Direct Loan Program Subsidy Expense

(Dollars in Millions)	2006	2005
Components of Current Year Subsidy Transfers		
Interest Rate Differential	$ (601)	$ (238)
Defaults, Net of Recoveries	1,226	355
Fees	(403)	(401)
Other	1,566	1,286
Current Year Subsidy Transfers	**1,788**	**1,002**
Subsidy Re-estimates	4,860	4,160
Loan Modification Costs	7	49
Direct Loan Subsidy Expense	**$ 6,655**	**$ 5,211**

In the 2006 re-estimates, Direct Loan subsidy expense was increased by $4.9 billion. Several factors accounted for this increase. Changes in the assumptions for the collections of defaulted loans contributed approximately $3.3 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) increased subsidy expense by $1.4 billion. A refinement of the Department's forecast using interest rate scenarios provided by OMB in a probabilistic approach accounted for an increase of $230 million. The subsidy rate is sensitive to interest rate fluctuations, for example a 1 percent increase in projected borrower base rates would reduce projected Direct Loan costs by $700 million. In the 2005 re-estimates, Direct Loan subsidy expense was increased by $4.2 billion. Changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) increased subsidy expense by $4.0 billion. The remaining $195 million increase was related to changes in actual and forecasted interest rates.

FFEL Program Loan Guarantee Subsidy Expense

(Dollars in Millions)	2006	2005
Components of Current Year Subsidy Transfers		
Interest Supplement Costs	$ 18,268	$ 12,562
Defaults, Net of Recoveries	1,665	865
Fees	(7,859)	(5,554)
Other	4,264	2,500
Current Year Subsidy Transfers	**16,338**	**10,373**
Subsidy Re-estimates	10,014	(658)
Loan Modification Costs	1,710	148
FFEL Loan Guarantee Subsidy Expense	**$ 28,062**	**$ 9,863**

In the 2006 re-estimates, FFEL subsidy expense was increased by $10.0 billion. Changes in interest rates account for an $8.9 billion increase in subsidy expense. Of this $8.9 billion increase, $6.2 billion is attributed to the change in interest supplement costs associated with higher than originally forecasted loan consolidations which occurred in late fiscal year 2006. In addition, the refinement of the Department's forecasting methodology, as noted above, accounted for an additional $1.8 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) decreased subsidy expense by $700 million on a net basis. The subsidy rate is sensitive to interest rate fluctuations, for example a 1 percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by $9.5 billion. In the 2005 re-estimates, FFEL subsidy expense was decreased by $658 million. An increase of $932 million was caused by changes in actual and forecasted interest rates. Changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) decreased subsidy expense by $1.6 billion.

Subsidy Rates

The subsidy rates applicable to the 2006 loan cohort year were as follows:

Subsidy Rates—Cohort 2006

	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program	(1.73%)	3.53%	(1.17%)	4.49%	5.12%
	Interest Supplements	**Defaults**	**Fees**	**Other**	**Total**
FFEL Program	14.44%	1.28%	(6.21%)	3.47%	12.98%

The subsidy rate represents the subsidy expense of the program in relation to the obligations or commitments made during the fiscal year. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department or third-party lenders disburse guaranteed loans. These subsidy rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense, nor are these rates applicable to the portfolio as a whole.

The costs of the Department's student loan programs, especially the Direct Loan Program, are highly sensitive to changes in actual and forecasted interest rates. The formulas for determining program interest rates are established by statute; the existing loan portfolio has a mixture of borrower and lender rate formulas. Interest rate projections are based on probabilistic interest rate scenario inputs developed and provided by the President's Office of Management and Budget.

Administrative Expenses

	2006		2005	
(Dollars in Millions)	Direct Loan	FFEL	Direct Loan	FFEL
Operating Expense	$ 342	$ 224	$ 401	$ 268
Other Expense	15	8	17	8
Administrative Expenses	**$ 357**	**$ 232**	**$ 418**	**$ 276**

Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In some statutorily defined cases, funds are provided to schools so that student loans may be cancelled. For certain defaulted loans, the Department reimburses the originating school and collects from the borrowers. These collections are transferred to the Treasury. At September 30, 2006 and 2005, loans receivable, net of an allowance for loss, were $192 and $194 million, respectively. These loans are valued at historical cost.

Facilities Loan Programs

The Department administers the College Housing and Academic Facilities Loan Program, the College Housing Loan Program, and the Higher Education Facilities Loan Program. From 1952 to 1993, these programs provided low-interest financing to institutions of higher education for the construction, reconstruction, and renovation of housing, academic, and other educational facilities. Since 1998, no new loans have been authorized.

The Department also administers the Historically Black Colleges and Universities (HBCU) Capital Financing Program. Since 1992, this program has given HBCUs access to financing for the repair, renovation, and, in exceptional circumstances, the construction or acquisition of facilities, equipment, and infrastructure through federally insured bonds. The Department has authorized a designated bonding authority to make the loans to eligible institutions, charge interest, and collect principal and interest payments. In compliance with statute, the bonding authority maintains an escrow account to pay the principal and interest on bonds for loans in default.

(Dollars in Millions)	2006	2005
Principal Receivable	$ 428	$ 427
Interest Receivable	6	6
Receivables	**434**	**433**
Less: Allowance for Subsidy	89	98
Credit Program Receivables, Net	**$ 345**	**$ 335**

Note 6. General Property, Plant and Equipment

(Dollars in Millions)	2006 Asset Cost	2006 Accumulated Depreciation	2006 Net Asset Value
IT Equipment and Software	$ 102	$ (74)	$ 28
Furniture and Fixtures	3	(2)	1
General Property, Plant and Equipment	**$ 105**	**$ (76)**	**$ 29**

(Dollars in Millions)	2005 Asset Cost	2005 Accumulated Depreciation	2005 Net Asset Value
IT Equipment and Software	$ 86	$ (68)	$ 18
Furniture and Fixtures	3	(2)	1
General Property, Plant and Equipment	**$ 89**	**$ (70)**	**$ 19**

The majority of the fiscal year 2006 and 2005 costs represent the acquisition and implementation of the financial management system and additional information technology and communications improvements.

Leases

The Department leases office space from the General Services Administration (GSA). The lease contracts with GSA for privately and publicly owned buildings are operating leases. Future lease payments are not accrued as liabilities, but expensed as incurred. Estimated future minimum lease payments for the privately owned buildings are presented below.

2006 (Dollars in Millions) Fiscal Year	Lease Payment	2005 (Dollars in Millions) Fiscal Year	Lease Payment
2007	$ 46	2006	$ 43
2008	47	2007	49
2009	49	2008	51
2010	53	2009	52
2011	56	2010	53
After 2011	58	After 2010	54
Total	**$ 309**	**Total**	**$ 302**

Note 7. Debt

	2006				
	Treasury				
(Dollars in Millions)	Direct Loans	Facilities Loans	Total	FFB	Total
Beginning Balance, Debt	$ 104,372	$ 100	$104,472	$ 125	$ 104,597
Accrued Interest	-	-	-	-	-
New Borrowing	33,278	-	33,278	44	33,322
Repayments	(32,220)	(7)	(32,227)	(15)	(32,242)
Ending Balance, Debt	**$ 105,430**	**$ 93**	**$ 105,523**	**$ 154**	**$ 105,677**

	2005				
	Treasury				
(Dollars in Millions)	Direct Loans	Facilities Loans	Total	FFB	Total
Beginning Balance, Debt	$ 96,421	$ 110	$ 96,531	$118	$ 96,649
Accrued Interest	(2)	-	(2)	-	(2)
New Borrowing	31,299	-	31,299	10	31,309
Repayments	(23,346)	(10)	(23,356)	(3)	(23,359)
Ending Balance, Debt	**$ 104,372**	**$ 100**	**$ 104,472**	**$ 125**	**$ 104,597**

The level of repayments on borrowings to Treasury is derived from many factors:

- Beginning-of-the-year cash balance, collections and borrowings have an impact on the available cash to repay Treasury.
- Cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

Note 8. Other Liabilities

(Dollars in Millions)	2006		2005	
Other Liabilities	**Intragovern-mental**	**With the Public**	**Intragovern-mental**	**With the Public**
Liabilities Covered by Budgetary Resources				
Current				
Advances From Others	$ 95	$ -	$ 85	$ 1
Employer Contributions and Payroll Taxes	3	-	3	-
Liability for Deposit Funds	(4)	30	(11)	21
Accrued Payroll and Benefits	-	15	-	15
Deferred Credits	-	1	-	1
Contractual Services	-	83	-	70
Total Other Liabilities Covered by Budgetary Resources	**94**	**129**	**77**	**108**
Liabilities Not Covered by Budgetary Resources				
Current				
Accrued Unfunded Annual Leave	-	31	-	30
Non-current				
Accrued Unfunded FECA Liability	3	-	3	-
Custodial Liability	-	204	-	204
Accrued FECA Actuarial Liability	-	17	-	17
Total Other Liabilities Not Covered by Budgetary Resources	**3**	**252**	**3**	**251**
Other Liabilities	**$ 97**	**$ 381**	**$ 80**	**$ 359**

Other liabilities include current and non-current liabilities. The non-current custodial liability primarily consists of the student loan receivables of the Perkins Loan Program. Annually, at September 30, the collections are returned to the general fund of the U.S. Treasury.

Liabilities not covered by budgetary resources include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources totaled $255 million and $254 million as of September 30, 2006 and 2005, respectively.

Liabilities covered by budgetary resources as of September 30, 2006 and 2005, totaled $167.4 billion and $143.5 billion, respectively.

Note 9. Accrued Grant Liability

The accrued grant liability by major reporting groups is shown in the table below. (See Note 1)

(Dollars in Millions)	2006	2005
FSA	$ 1,250	$ 635
OESE	258	248
OSERS	171	90
Other	380	355
Accrued Grant Liability	**$ 2,059**	**$ 1,328**

Note 10. Net Position

Unexpended Appropriations (Dollars in Millions)	**2006**	**2005**
Unobligated Balances		
Available	$ 4,056	$ 526
Not Available	316	380
Undelivered Orders, end of period	47,440	46,382
Unexpended Appropriations	**$ 51,812**	**$ 47,288**

The Cumulative Results of Operations-Earmarked Funds as of September 30, 2006, totaled $61 million and represents donations from foreign governments, international entities and individuals to support Katrina relief and recovery efforts. (See Note 15) The Cumulative Results of Operations-Other Funds of $(5,063) million as of September 30, 2006, and $(4,446) million as of September 30, 2005, consist mostly of net investments of capitalized assets and unfunded expenses, including upward subsidy re-estimates for loan programs.

Note 11. Intragovernmental Cost and Exchange Revenue by Program Segment

As required by the *Government Performance and Results Act*, each of the Department's Reporting Organizations (see Note 1) has been aligned with the major goals presented in the Department's *Strategic Plan 2002—2007*.

Net Cost Program	**Reporting Organizations**	**No.**	**Strategic Goal**
Enhancement of Postsecondary and Adult Education	FSA OPE OVAE	5	Enhance the Quality of and Access to Postsecondary and Adult Education
Creation of Student Achievement, Culture of Achievement and Safe Schools	OESE OELA OSDFS	2 3	Improve Student Achievement Develop Safe and Drug-Free Schools
Transformation of Education	IES OII	4	Transform Education into an Evidence-Based Field
Special Education and Program Execution	OSERS		Cuts across Strategic Goals 2, 3, 4, and 5

The Department considers strategic Goal 1, Create a Culture of Achievement, a synopsis of the four pillars on which educational excellence is established, and Strategic Goal 6, Establishing Management Excellence, which emphasizes administrative and oversight responsibilities, to be high-level premises on which the Department bases its foundation for each of the other four strategic goals. These two strategic goals support our programmatic mission, and as a result, we do not assign specific programs to either of these strategic goals for presentation in the Statement of Net Cost. Goals 2 through 5 are sharply defined directives that guide divisions of the Department to carry out the vision and programmatic mission, and the Net Cost programs can be specifically associated with these four strategic goals.

Intragovernmental Cost and Exchange Revenue by Program Segment

2006

(Dollars in Millions)	FSA	OESE	OSERS	Other	Total
Enhancement of Postsecondary and Adult Education					
Intragovernmental Gross Cost	$ 7,857	$ -	$ -	$ 81	$ 7,938
Gross Costs with the Public	50,946	-	-	4,472	55,418
Total Program Costs	58,803	-	-	4,553	63,356
Less: Intragovernmental Earned Revenue	(3,131)	-	-	(1)	(3,132)
Earned Revenue from the Public	(4,641)	-	-	(17)	(4,658)
Total Program Revenue	(7,772)	-	-	(18)	(7,790)
Creation of Student Achievement, Culture of Achievement and Safe Schools					
Intragovernmental Gross Cost	-	172	-	20	192
Gross Costs with the Public	-	21,754	-	2,659	24,413
Total Program Costs	-	21,926	-	2,679	24,605
Less: Intragovernmental Earned Revenue	-	-	-	(60)	(60)
Earned Revenue from the Public	-	-	-	-	-
Total Program Revenue	-	-	-	(60)	(60)
Transformation of Education					
Intragovernmental Gross Cost	-	-	-	81	81
Gross Costs with the Public	-	-	-	1,282	1,282
Total Program Costs	-	-	-	1,363	1,363
Less: Intragovernmental Earned Revenue	-	-	-	(4)	(4)
Earned Revenue from the Public	-	-	-	(14)	(14)
Total Program Revenue	-	-	-	(18)	(18)
Special Education and Program Execution					
Intragovernmental Gross Cost	-	-	151	-	151
Gross Costs with the Public	-	-	15,224	-	15,224
Total Program Costs	-	-	15,375	-	15,375
Less: Intragovernmental Earned Revenue	-	-	(2)	-	(2)
Earned Revenue from the Public	-	-	-	-	-
Total Program Revenue	-	-	(2)	-	(2)
Net Cost of Operations	**$51,031**	**$21,926**	**$15,373**	**$8,499**	**$96,829**

2005

(Dollars in Millions)	FSA	OESE	OSERS	Other	Total
Enhancement of Postsecondary and Adult Education					
Intragovernmental Gross Cost	$ 7,055	$ -	$ -	$ 86	$ 7,141
Gross Costs with the Public	30,952	-	-	4,258	35,210
Total Program Costs	38,007	-	-	4,344	42,351
Less: Intragovernmental Earned Revenue	(2,140)	-	-	-	(2,140)
Earned Revenue from the Public	(4,705)	-	-	(25)	(4,730)
Total Program Revenue	(6,845)	-	-	(25)	(6,870)
Creation of Student Achievement, Culture of Achievement and Safe Schools					
Intragovernmental Gross Cost	-	166	-	20	186
Gross Costs with the Public	-	23,023	-	1,255	24,278
Total Program Costs	-	23,189	-	1,275	24,464
Less: Intragovernmental Earned Revenue	-	(17)	-	(59)	(76)
Earned Revenue from the Public	-	-	-	-	-
Total Program Revenue	-	(17)	-	(59)	(76)
Transformation of Education					
Intragovernmental Gross Cost	-	-	-	82	82
Gross Costs with the Public	-	-	-	1,138	1,138
Total Program Costs	-	-	-	1,220	1,220
Less: Intragovernmental Earned Revenue	-	-	-	(3)	(3)
Earned Revenue from the Public	-	-	-	(14)	(14)
Total Program Revenue	-	-	-	(17)	(17)
Special Education and Program Execution					
Intragovernmental Gross Cost	-	-	94	-	94
Gross Costs with the Public	-	-	14,075	-	14,075
Total Program Costs	-	-	14,169	-	14,169
Less: Intragovernmental Earned Revenue	-	-	(2)	-	(2)
Earned Revenue from the Public	-	-	-	-	-
Total Program Revenue	-	-	(2)	-	(2)
Net Cost of Operations	**$31,162**	**$23,172**	**$14,167**	**$6,738**	**$75,239**

Note 12. Interest Expense and Interest Revenue

(Dollars in millions)	Direct Loan Program 2006	Direct Loan Program 2005	FFEL Program 2006	FFEL Program 2005	Other Programs 2006	Other Programs 2005	Total 2006	Total 2005
Federal	$ 6,505	$ 6,171	$ 1,110	$ 565	$ 15	$ 15	$ 7,630	$ 6,751
Non-federal	-	-	-	-	-	-	-	-
Interest Expense	**$ 6,505**	**$ 6,171**	**$ 1,110**	**$ 565**	**$ 15**	**$ 15**	**$ 7,630**	**$ 6,751**
Federal	$ 1,926	$ 1,475	$ 1,110	$ 565	$ -	$ -	$ 3,036	$ 2,040
Non-federal	4,579	4,696	-	-	19	26	4,598	4,722
Interest Revenue	**$ 6,505**	**$ 6,171**	**$ 1,110**	**$ 565**	**$ 19**	**$ 26**	**$ 7,634**	**$ 6,762**

For the Direct Loan Program, interest expense is recognized on the Department's borrowings from Treasury. The interest revenue is earned on the individual loans in the loan portfolio, while federal interest is earned on the uninvested fund balances with Treasury. For the FFEL Program, federal interest revenue is earned on the uninvested fund balance with Treasury in the financing fund. The Direct Loan Program and the FFEL Program are included on the Statement of Net Cost in Enhancement of Postsecondary and Adult Education.

Note 13. Statement of Budgetary Resources

The Statement of Budgetary Resources (SBR) compares budgetary resources with the status of those resources. As of September 30, 2006, budgetary resources were $210,921 million and net outlays were $70,645 million. As of September 30, 2005, budgetary resources were $154,095 million and net outlays were $69,808 million.

Permanent Indefinite Budget Authority

The Direct Loan Program and the Federal Family Education Loan Program were granted permanent indefinite budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and Part B of the Federal Family Education Loan Program, pursuant to the HEA, pertains to the existence, purpose, and availability of this permanent indefinite budget authority.

Reauthorization of Legislation

Funds for most Department programs are authorized, by statute, to be appropriated for a specified number of years, with an automatic one-year extension available under Section 422 of the *General Education Provisions Act*. Congress may continue to appropriate funds after the expiration of the statutory authorization period, effectively reauthorizing the program through the appropriations process. The current *Budget of the United States Government* presumes all programs continue per congressional budgeting rules.

Apportionment Categories of Obligations Incurred

(Dollars in Millions)	2006	2005
Direct:		
Category A	$ 1,298	$ 1,308
Category B	157,644	127,489
Exempt from Apportionment	176	252
	159,118	129,049
Reimbursable:		
Category A	-	4
Category B	-	3
Exempt from Apportionment	92	85
	92	92
Apportionment Categories of Obligations Incurred	**$ 159,210**	**$ 129,141**

Category A apportionments are those resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by the OMB.

Unused Borrowing Authority

(Dollars in Millions)	2006	2005
Beginning Balance, Unused Borrowing Authority	$ 5,481	$ 5,952
Current Year Borrowing Authority	35,089	32,209
Funds Drawn From Treasury	(33,322)	(31,309)
Prior Year Unused Borrowing Authority Cancelled	-	(1,326)
Other	-	(45)
Ending Balance, Unused Borrowing Authority	**$ 7,248**	**$ 5,481**

The Department is given authority to draw funds from the Treasury to help finance the majority of its direct lending activity. Unused Borrowing Authority is a budgetary resource and is available to support obligations. The Department periodically reviews its borrowing authority balances in relation to its obligations and may cancel unused amounts.

Undelivered Orders at the End of the Period

	2006		2005	
(Dollars in Millions)	Budgetary	Non-Budgetary	Budgetary	Non-Budgetary
Undelivered Orders at the end of the period	**$ 47,630**	**$ 12,472**	**$ 46,493**	**$ 10,472**

Undelivered orders at the end of the year, as presented above, will differ from the undelivered orders included in the Net Position, Unexpended Appropriations. Undelivered orders for trust funds and federal credit financing and liquidating funds are not funded through appropriations and are not included in Net Position. (See Note 10)

Explanation of Differences Between the Statement of Budgetary Resources and the *Budget of the United States Government*

The *FY 2008 Budget of the United States Government* (President's Budget) presenting the actual amounts for the year ended September 30, 2006 has not been published as of the issue date of these financial statements. The FY 2008 President's Budget is scheduled for publication in February 2007. A reconciliation of the FY 2005 column on the SBR to the actual amounts for FY 2005 in the FY 2007 President's Budget for budgetary resources, obligations incurred, distributed offsetting receipts and net outlays is presented below.

(Dollars in Millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Combined Statement of Budgetary Resources	$ 154,095	$ 129,141	$ 32	$ 69,808
Less: Expired Funds	(882)	(527)	-	-
Add: Amounts included in the President's Budget	5,325	5,325	-	-
Less: Funds excluded from President's Budget and Rounding	4	6	-	(4)
Plus: Distributed Offsetting Receipts				32
Budget of the United States Government	**$ 158,542**	**$ 133,945**	**$ 32**	**$ 69,836**

Budgetary accounting as shown in the President's Budget includes a public enterprise fund that reflects the net obligations by the FFEL Program for the estimated activity of the consolidated Federal Funds of the Guaranty Agencies. The consolidated balance of the Federal Fund accounts reflected in the financial statements represents actual cash activity, resulting in timing difference as shown on the Statement of Budgetary Resources. In 2005, obligations of $4,977 million were recorded and $4,725 million in offsetting collections transferred to Guaranty Agency Federal Fund accounts from the Department. Collections from non-federal sources of $100 million were deposited in 2005.

Note 14. Statement of Financing

The Statement of Financing (SOF) provides information on the total resources used by an agency, both those received through budgetary resources and those received through other means during the reporting period. The statement reconciles these resources with the net cost of operations by (1) removing resources that do not fund net cost of operations, and (2) including components of net cost of operations that did not generate or use resources during the year.

The SOF is presented as a consolidated statement for the Department and its major programs. Net interagency eliminations are presented for proprietary amounts. The budgetary amounts are reported on a combined basis as presented in the Statement of Budgetary Resources. Accordingly, net interagency eliminations for budget amounts are not presented.

The difference between the amounts reported as liabilities not covered by budgetary resources on the Balance Sheet and amounts reported as Other Components Requiring or Generating Resources in Future Periods on the Statement of Financing represents an increase in custodial liability activities.

Components Not Requiring or Generating Resources primarily result from the subsidy expense recognized for financial statement re-estimate purposes as required by the Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*. Re-estimates published in the President's Budget generate or require resources.

Note 15. 2005 Hurricane Relief

On August 29, 2005, hurricane Katrina struck the Gulf Coast, resulting in widespread catastrophic damage to the coastal regions of Louisiana, Mississippi and Alabama. Immediately following Katrina, hurricane Rita struck the same region, adding Texas to the states already catastrophically damaged and hindering the recovery efforts. The death toll, property damage, dislocation of families, and destruction of the infrastructure of the communities and economies of the Gulf Coast represent a humanitarian crisis that will affect these areas for many years to come.

The Department of Education quickly responded by accelerating the application process for the region's loan applicants, students, borrowers, Guaranty Agencies, educational institutions and other program participants to expedite education-related relief. In addition, the Secretary was authorized to waive or modify statutory or regulatory provisions as applicable for student financial assistance programs. While this provided some relief for the coastal regions, it was apparent that the damage to the affected communities required significant financial support to rebuild the educational systems and return students and teachers to their classrooms.

Funds Appropriated for Hurricane Relief

The *Hurricane Education Recovery Act* (PL 109-148) was enacted on December 30, 2005. The act appropriated $1.6 billion to the Department. This funding provides needed assistance to reopen schools and helps educate the 370,000 students affected by hurricanes Katrina and Rita. In June 2006, an additional $285 million was transferred to the Department to assist with the relief efforts. As of September 30, 2006, $1.9 billion in aid has been obligated to assist local educational agencies and non-public schools and approximately $1.1 billion has been expended. The remaining funds will be released following review of applications from the educational agencies and non-public schools.

(Dollars in Millions)	Appropriated	Obligated	Expended
Emergency Impact Aid for Displaced Students (Impact Aid) Program	$ 880	$ 878	$ 739
Immediate Aid to Restart School Operations (Restart Aid) Program	750	750	233
Higher Education Relief	250	250	168
Assistance for Homeless Youth (Homeless Aid) Program	5	5	-
2005 Hurricane Disaster Relief	**$ 1,885**	**$ 1,883**	**$ 1,140**

Earmarked Funds Donated for Hurricane Relief

In the aftermath of hurricane Katrina, a number of foreign governments, international entities and individuals made donations of financial assistance to the U.S. Government to support Katrina relief and recovery efforts. These donations were received by the U.S. Department of State as an intermediary. Subsequently, $60.5 million was transferred to the Department to finance educational initiatives in Louisiana and Mississippi under a Memorandum of Understanding issued in March 2006. Applications are being received from the affected areas and are being reviewed. As of September 30, 2006, $35.2 million has been obligated from the earmarked funds to assist in the relief and recovery efforts.

Note 16. Contingencies

Guaranty Agencies

The Department can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

Perkins Loan Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In fiscal year 2006, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the latest academic year ended June 30, 2006, approximately 727,546 loans were made, totaling approximately $1.6 billion at 1,666 institutions, averaging $2,178 per loan. The Department's share of the Perkins Loan Program was approximately $6.5 billion as of June 30, 2006.

In fiscal year 2005, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the academic year ended June 30, 2005, approximately 779,129 loans were made, totaling $1.6 billion at 1,653 institutions, averaging $2,069 per loan. The Department's share of the Perkins Loan Program was approximately $6.4 billion as of June 30, 2005.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, in nursing, or in family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances, a contingency is deemed to exist. The Department may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial position.

Other Matters

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures that were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial position.

During the fiscal year, the Inspector General issued an audit report that questioned payments made to an entity that participates in the Federal Family Education Loan Program. The findings cited in this report are under consideration by the Department. Until the matter is resolved, the potential impact, if any, on the Department's financial position is not possible to estimate.