Notes to Principal Financial Statements

For the Years Ended September 30, 2005 and 2004

Note 1. Summary of Significant Accounting Policies

Reporting Entity

The U.S. Department of Education (the Department) was established on May 4, 1980, by Congress, 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 Federal Direct Student Loan Program (Direct Loan), the Federal Family Education Loan Program (FFEL), the Pell Grant Program and the Campus-Based Student Aid Program. 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, 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. The Pell Grant Program and the Campus-Based Program provide educational grants and other financial assistance to eligible applicants.

The Department also administers numerous grant programs and the Facilities Loan Programs. Grant programs include grants for elementary and secondary education, special education and rehabilitative services, and educational research and improvement, along with 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 facilities.

Organization and Structure of Education

The statements consolidate 230 discrete appropriations comprising 64 fund accounts within the following 10 reporting groups:

- Federal Student Aid
- Office of Elementary and Secondary Education
- Office of Special Education and Rehabilitative Services
- Office of Vocational and Adult Education
- Office of Postsecondary Education
- Institute of Education Sciences
- Office of English Language Acquisition
- Office of Safe and Drug-Free Schools
- Office of Innovation and Improvement
- Department Management

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 and Office of Management and Budget (OMB) Circular No. A-136 (Revised), *Financial Reporting Requirements*. Generally accepted accounting principles (GAAP) for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is the official standard setting body for the federal government. These financial statements are different from the financial reports prepared by the Department pursuant to 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 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 requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

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 assumption components may create significant changes to the estimate.

The Department recognizes the sensitivity of the changes in assumptions and the impact that the projections can have on estimates. Management has attempted to mitigate these fluctuations by using trend analysis to project future cash flows. The assumptions used for the September 30, 2005 and 2004, financial statements are based on the best information available at the time the estimate was derived.

Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a long-term change in the projected interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount.

The Student Loan Model (SLM) and estimating methods used are updated periodically to reflect changing conditions. The SLM was the official estimating model of the Department as of

September 30, 2005 and 2004, and was used to calculate the subsidy re-estimates recorded in these financial statements.

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 for fiscal years 2005 and 2004 included (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.

Treasury Debt provides most of the funding for the loan principal disbursements made under the Federal Direct Student 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 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. (See Note 2.)

Cash and Other Monetary Assets

Cash and other monetary assets consist of Guaranty Agency reserves and deposits in transit. Guaranty Agency reserves represent the Department's interest in the net assets of the FFEL Program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 3) 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 purchased out of reserve funds.

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. However, such ownership by the Department is independent of the actual control of the assets.

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 (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.

Accounts Receivable

Accounts receivable are amounts due to the Department from the public and other federal agencies. Receivables from the public typically result from such items as disputed costs resulting from audits of educational assistance, whereas amounts due from other federal agencies result from 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 experience in the collection of receivables and an analysis of the outstanding balances. (See Note 5.)

Credit Program Receivables and Liabilities for Loan Guarantees

The financial statements at September 30, 2005 and 2004 reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the *Federal Credit Reform Act of 1990*. 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 expected 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 involved with 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 4.)

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 software 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 Departmental 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.

Treasury Debt

The amount shown for the liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with the Department's 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 4, the interest received by the Department from borrowers will vary from the rate paid to the Treasury. Principal and interest payments are made annually. (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 receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 11.)

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except those 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 12.)

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 50 percent 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 to Labor by the Department. As a result, the Department recognizes a liability 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 Office of Management and Budget 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.

Labor evaluates the estimated projections to ensure that the resulting projections were reliable. The analysis includes three tests: (1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments; (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection; and (3) a comparison of the incremental paid losses (the medical component in particular) in congressional budget year 2005 (by injury cohort) to the average pattern observed during the prior three charge back 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. The Department is subject to financial regulation and management control by the Office of Management and Budget and Treasury. As a result of this relationship, 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.

Other Intragovernmental Assets

Other intragovernmental assets represent interagency agreements between the Department and the National Science Foundation. As of September 30, 2005 and 2004, other intragovernmental assets totaled $12 million and $17 million, respectively. This amount represents unexpended balances for interagency agreements with the Department.

Note 2. Fund Balance with Treasury

Fund Balance with Treasury at September 30, 2005 and 2004, consisted of the following:

(Dollars in Millions)	2005	2004
Appropriated Funds	$ 49,455	$ 49,353
Revolving Funds	28,104	17,010
Other Funds	10	8
Total Fund Balance with Treasury	**$ 77,569**	**$ 66,371**

Status of Fund Balance with Treasury

(Dollars in Millions)	2005	2004
Unobligated Balance		
Available	$ 526	$ 1,603
Unavailable	23,540	14,738
Obligated Balance, Not Yet Disbursed	53,493	50,022
Other Funds	10	8
Total Status of Fund Balance with Treasury	**$ 77,569**	**$ 66,371**

Fund Balance with Treasury is an entity asset maintained with Treasury. The monies are available to pay current liabilities and finance loan programs. The Department has the authority to disburse funds to agencies and institutions participating in its programs through the Treasury, which processes cash receipts and disbursements on its behalf.

A portion of the appropriated funds included at September 30, 2005 and 2004, was 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 do not require annual appropriations. Their fund balance comes from other federal entities and the public collections and from borrowings. Other funds primarily consist of suspense, deposit funds 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 reimbursements and other income earned, undelivered orders and unpaid expended authority.

Note 3. Cash and Other Monetary Assets

Cash and Other Monetary Assets consisted of Guaranty Agency reserves (non-entity assets) and deposits in transit as of September 30, 2005 and 2004.

	2005		
(Dollars in Millions)	Guaranty Agency Reserves	Deposits in Transit	Total
Beginning Balance, September 30	$ 1,040	$ -	$ 1,040
Current Year Activity	(152)	-	(152)
Ending Balance, September 30	**$ 888**	**$ -**	**$ 888**

	2004		
(Dollars in Millions)	Guaranty Agency Reserves	Deposits in Transit	Total
Beginning Balance, September 30	$ 1,107	$ 1	$ 1,108
Current Year Activity	(67)	(1)	(68)
Ending Balance, September 30	**$ 1,040**	**$ -**	**$ 1,040**

Guaranty Agency reserves are held on behalf of the U.S. government, a liability due to Treasury and considered intragovernmental liabilities. These balances represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. (See Note 1.)

On September 30, 2005 and 2004, Guaranty Agencies held in the Federal Fund approximately $888 million and $1,040 million in federal assets, respectively. The agencies use the funds to pay lender claims, primarily for loan defaults and discharges. Consistent with Section 422A (e) of the *HEA*, these funds are considered property of the United States and are reflected in the *Budget of the United States Government.*

Note 4. Credit Program Receivables and Liabilities for Loan Guarantees

The Department operates the William D. Ford Direct Student Loan Program (Direct Loan) and Federal Family Education Loan Program (FFEL) to help students finance the costs of higher education. Under the programs, the Department makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income or credit rating. Student borrowers who demonstrate financial need also receive federal interest subsidies.

Under the Direct Loan Program, the federal government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL Program, more than 3,200 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the federal government against default, with 35 state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees. Beginning with 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 funds they hold in trust. 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 *Federal Credit Reform Act of 1990 (the Act of 1990)* 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 Act of 1990, subsidy costs for loans obligated beginning in fiscal year 1992 are the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually through the re-estimate process.

The Department estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy 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 Direct Loan and guaranteed FFEL programs. 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 2006 Mid-Session Review, a governmentwide exercise required annually by the Office of Management and Budget (OMB). Assumptions regarding the volume of loan consolidations and their impact on newly repaid loans were updated after the Mid-Session Review to account for significant subsequent increases in activity. These estimates are the most current 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.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the *Federal Credit Reform Act of 1990* 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 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 $27.5 billion in direct loans to eligible borrowers in fiscal year 2005 and approximately $20 billion in fiscal year 2004. Loans typically disburse 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, 2005 and 2004, total principal balances outstanding of guaranteed loans held by lenders were approximately $289 billion and $245 billion, respectively. As of September 30, 2005 and 2004, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately $288 billion and $240 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 funds. 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 is calculated but only realized upon collection.

As previously noted, borrowers may prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivables include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated future consolidation loans.

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 2005, an estimated $1.6 billion will not be disbursed; for guaranteed loans committed in fiscal year 2005, an estimated $7.1 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

Variable student loan interest rates were reset on July 1, 2005, increasing nearly two percentage points from 3.37 percent for academic year 2004-05 to 5.30 percent for academic year 2005-06. In anticipation of this increase, private lenders, schools, and others encouraged borrowers to consolidate their existing variable rate loans into fixed rate loans. This resulted in an unprecedented surge in loan consolidations, leading to substantially higher volume than the previous fiscal year.

Direct loan consolidation disbursements for fiscal year 2005 were $15.3 billion compared to $7.7 billion for fiscal year 2004. The effect of new consolidations is reflected in subsidy expense for the 2005 cohort, while the effect on prior cohorts of the pay-offs of underlying loans is reflected in re-estimate expense.

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 2005 cohort resulting in increased prepayments of underlying loans from prior cohorts. The effect of new consolidations is reflected in subsidy expense for the 2005 cohort, while the effect on prior cohorts is reflected in the re-estimate.

Credit Program Receivables, Net

The Credit Program Receivables, Net consisted of the following program loans:

(Dollars in Millions)	2005	2004
Direct Loan Program Loan Receivables, Net	$ 95,696	$ 93,747
FFEL Program Loan Receivables, Net	11,712	10,671
Perkins Program Loan Receivables, Net	194	194
Facilities and Other Loan Receivables, Net	335	354
Credit Program Receivables, Net	**$ 107,937**	**$ 104,966**

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

Direct Loan Program Receivables

(Dollars in Millions)	2005	2004
Principal Receivable	$ 94,707	$ 89,245
Interest Receivable	3,121	2,858
Receivables	**97,828**	**92,103**
Less: Allowance for Subsidy	2,132	(1,644)
Credit Program Receivables, Net	**$ 95,696**	**$ 93,747**

Of the $97.8 billion in Direct Loan receivables as of September 30, 2005, $7.2 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2004, $6.3 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group out of a total receivable of $92.1 billion.

FFEL Program Receivables

	2005			2004		
(Dollars in Millions)	Pre-1992	Post-1991	Total	Pre-1992	Post-1991	Total
Principal Receivable	$ 9,306	$ 8,567	$ 17,873	$ 10,324	$ 7,247	$ 17,571
Interest Receivable	595	1,691	2,286	857	1,580	2,437
Receivables	**9,901**	**10,258**	**20,159**	**11,181**	**8,827**	**20,008**
Less: Allowance for Subsidy	6,736	1,711	8,447	7,921	1,416	9,337
Credit Program Receivables, Net	**$ 3,165**	**$ 8,547**	**$ 11,712**	**$ 3,260**	**$ 7,411**	**$ 10,671**

Direct Loan Program Reconciliation of Allowance for Subsidy

(Dollars in Millions)	2005	2004
Beginning Balance, Allowance for Subsidy	**$ (1,644)**	**$ 657**
Components of Subsidy Transfers		
Interest Rate Differential	(238)	(1,276)
Defaults, Net of Recoveries	355	390
Fees	(401)	(401)
Other	1,286	1,117
Current Year Subsidy Transfers	**1,002**	**(170)**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates[1]	1,703	(1,526)
Technical and Default Re-estimates	2,457	1,153
Subsidy Re-estimates	**4,160**	**(373)**
Components of Teacher Loan Forgiveness Modification		
Loan Modification Costs	49	-
Modification Adjustment Transfers	(1)	-
Teacher Loan Forgiveness Modification	**48**	**-**
Activity		
Fee Collections	461	450
Loan Cancellations[2]	(110)	(92)
Subsidy Allowance Amortization	(1,454)	(1,815)
Other	(331)	(301)
Total Activity	**(1,434)**	**(1,758)**
Ending Balance, Allowance for Subsidy	**$ 2,132**	**$ (1,644)**

[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.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

Liabilities for Loan Guarantees represent the present value of all future projected cash outflows from the Department, net of inflows such as fees, and collection of principal and interest on defaulted guaranteed loans assumed for direct collection.

The FFEL Program Liability for Loan Guarantees reconciliation is associated with the FFEL Program loans guaranteed in the financing account. The FFEL liquidating account liability for loan guarantees is included in the total Liabilities for Loan Guarantees.

(Dollars in Millions)	2005	2004
Beginning Balance, Liability for Loan Guarantees	**$ 23,214**	**$ 15,310**
Components of Subsidy Transfers		
Interest Supplement Costs	12,562	10,087
Defaults, Net of Recoveries	865	888
Fees	(5,554)	(4,230)
Other[1]	2,500	2,151
Current Year Subsidy Transfers	**10,373**	**8,896**
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	(72)	70
Technical and Default Re-estimates	(586)	(1,449)
Subsidy Re-estimates	**(658)**	**(1,379)**
Components of Teacher Loan Forgiveness Modification		
Loan Modification Costs	148	-
Modification Adjustment Transfers	(3)	-
Teacher Loan Forgiveness Modification	**145**	**-**
Activity		
Interest Supplement Payments	(5,077)	(2,345)
Claim Payments	(3,716)	(2,803)
Fee Collections	3,060	2,588
Interest on Liability Balance	565	436
Other[2]	2,594	2,511
Total Activity	**(2,574)**	**387**
Ending Balance, Liability for Loan Guarantees	**30,500**	**23,214**
FFEL Liquidating Account Liability for Loan Guarantees	111	115
Total Liabilities for Loan Guarantees	**$ 30,611**	**$ 23,329**

[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.

Teacher Loan Forgiveness Modification of Subsidy Cost

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, as described in Dear Colleague letter GEN-04-14. According to OMB Circular No. A-11, Section 185.3, 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 any outstanding loan guarantee is defined as a modification. The FFEL Program recognized $148 million and the Direct Loan Program recognized $49 million in modification costs in fiscal year 2005.

Separate amounts are calculated for modification costs and modification adjustment transfers. Modification adjustment transfers are required to adjust for the difference between cohort discount rates used to calculate modification costs and the discount rates used to calculate cohort interest expense and revenue. The FFEL Program recognized a net modification adjustment transfer gain of $3 million, while the Direct Loan Program recognized a net gain of $1 million.

Direct Loan Financing Account Interest Expense and Revenue

The Direct Loan Financing Account borrows from Treasury to fund the unsubsidized portion of its lending activities and, as required, calculates and pays Treasury interest at the end of each year. Interest is earned on the outstanding Direct Loan portfolio during the year. The Financing Account is paid interest by Treasury 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 (SFFAS 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.

Direct Loan Financing Account Interest Expense and Revenue

(Dollars in Millions)	2005	2004
Interest Expense on Treasury Borrowing	$ 6,171	$ 5,761
Interest Expense	**$ 6,171**	**$ 5,761**
Interest Revenue from the Public	$ 3,242	$ 2,946
Amortization of Subsidy	1,454	1,815
Interest Revenue on Uninvested Funds	1,475	1,000
Interest Revenue	**$ 6,171**	**$ 5,761**

Subsidy Expense

Direct Loan Program Subsidy Expense

(Dollars in Millions)	2005	2004
Components of Current Year Subsidy Transfers		
Interest Rate Differential	$ (238)	$ (1,276)
Defaults, Net of Recoveries	355	390
Fees	(401)	(401)
Other	1,286	1,117
Current Year Subsidy Transfers	**1,002**	**(170)**
Subsidy Re-estimates	4,160	(373)
Loan Modification Costs	49	-
Direct Loan Subsidy Expense	**$ 5,211**	**$ (543)**

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 is related to changes in actual and forecasted interest rates. A 1 percent increase in projected borrower base rates would reduce projected Direct Loan costs by $1.1 billion. In the 2004 re-estimates, Direct Loan subsidy expense was reduced by $373 million. Changes in actual and forecasted interest rates reduced subsidy expense by $847 million. The re-estimate related to changes in assumptions for other variables increased subsidy expense by $474 million.

FFEL Program Loan Guarantee Subsidy Expense

(Dollars in Millions)	2005	2004
Components of Current Year Subsidy Transfers		
Interest Supplement Costs	$ 12,562	$ 10,087
Defaults, Net of Recoveries	865	888
Fees	(5,554)	(4,230)
Other	2,500	2,151
Current Year Subsidy Transfers	**10,373**	**8,896**
Subsidy Re-estimates	(658)	(380)
Loan Modification Costs	148	-
FFEL Loan Guarantee Subsidy Expense	**$ 9,863**	**$ 8,516**

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. A 1 percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by $6.4 billion. In the 2004 re-estimates, FFEL subsidy expense was reduced by $380 million, of which changes in actual and forecasted interest rates reduced subsidy expense by $352 million. The re-estimate related to changes in assumptions for other variables reduced subsidy expense by $28 million.

Subsidy Rates

The subsidy rates applicable to the 2005 loan cohort year were as follows:

Subsidy Rates—Cohort 2005

	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program	(.60%)	1.16%	(1.33%)	4.24%	3.47%
	Interest Supplements	**Defaults**	**Fees**	**Other**	**Total**
FFEL Program	13.66%	.93%	(6.01%)	2.67%	11.25%

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 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.

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. Governmentwide interest rate projections are developed by the President's Office of Management and Budget.

Administrative Expenses

The administrative expenses for Direct Loan and FFEL programs were as follows:

	2005		2004	
(Dollars in Millions)	Direct Loan	FFEL	Direct Loan	FFEL
Operating Expense	$ 401	$ 268	$ 409	$ 281
Other Expense	17	8	10	-
Total Administrative Expenses	**$ 418**	**$ 276**	**$ 419**	**$ 281**

Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In fiscal year 2004, new federal capital contributions of $99 million were provided to make loans to eligible students through participating schools at 5 percent interest. No new federal capital contributions were appropriated in fiscal year 2005. 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, 2005 and 2004, loans receivable, net of an allowance for loss, were $194 million. These loans are valued at historical cost.

Facilities Loan Programs

The Department administers the College Housing and Academic Facilities Loan Program (CHAFL), the College Housing Loan Program (CHL), and the Higher Education Facilities Loan Program (HEFL). 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 Capital Financing Program (HBCU). 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.

The credit program receivables were as follows:

(Dollars in Millions)	2005	2004
Principal Receivable	$ 427	$ 452
Interest Receivable	6	6
Receivables	**433**	**458**
Less: Allowance for Subsidy	98	104
Credit Program Receivables, Net	**$ 335**	**$ 354**

Note 5. Accounts Receivable

Accounts receivable consisted of the following at September 30, 2005 and 2004:

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

	2004		
(Dollars in Millions)	Gross Receivables	Allowance	Net Receivables
Intragovernmental	$ 3	$ -	$ 3
With the Public	377	(225)	152
Total Accounts Receivable	**$ 380**	**$ (225)**	**$ 155**

Accounts receivable represent balances due from recipients of grant and other financial assistance programs, and reimbursable agreements from other federal agencies. They are recorded at their estimated net realizable value. Estimates for the allowance for loss on uncollectible accounts are based on historical data.

Note 6. General Property, Plant and Equipment

General property, plant and equipment consisted of the following at September 30, 2005 and 2004:

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

	2004		
(Dollars in Millions)	Asset Cost	Accumulated Depreciation	Net Asset Value
IT Equipment and Software	$ 76	$ (57)	$ 19
Furniture and Fixtures	3	(1)	2
Total General Property, Plant and Equipment	**$ 79**	**$ (58)**	**$ 21**

Information Technology (IT) equipment consists of computer hardware and related software. The majority of the fiscal year 2005 and 2004 costs represent the acquisition and implementation of the financial management system, and additional information technology and communications improvements. Furniture and fixtures and building improvements are related to renovating and furnishing new quarters for FSA and PCP.

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 privately owned buildings as of September 30, 2005 and 2004, were as follows:

2005 (Dollars in Millions)		2004 (Dollars in Millions)	
Fiscal Year	Lease Payment	Fiscal Year	Lease Payment
2006	$ 43	2005	$ 46
2007	49	2006	55
2008	51	2007	61
2009	52	2008	63
2010	53	2009	64
After 2010	54	After 2009	66
Total	**$ 302**	**Total**	**$ 355**

Note 7. Treasury Debt

The Department's Debt to the Treasury and the Federal Financing Bank (FFB) as of September 30, 2005, consists of the following:

	2005				
	Treasury				
(Dollars in Millions)	Direct Loans	Facilities Loans	Total	FFB	Total
Beginning Balance	$ 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	**$ 104,372**	**$ 100**	**$ 104,472**	**$ 125**	**$ 104,597**

The Department's Debt to the Treasury and FFB as of September 30, 2004, consisted of the following:

	2004				
	Treasury				
(Dollars in Millions)	Direct Loans	Facilities Loans	Total	FFB	Total
Beginning Balance	$ 91,787	$ 151	$ 91,938	$ 80	$ 92,018
Accrued Interest	1	-	1	2	3
New Borrowing	21,191	-	21,191	53	21,244
Repayments	(16,558)	(41)	(16,599)	(17)	(16,616)
Ending Balance	**$ 96,421**	**$ 110**	**$ 96,531**	**$ 118**	**$ 96,649**

Funds were borrowed to provide funding for direct loans to students and facilities loan programs. In addition, the FFB holds bonds issued by the Department on behalf of the HBCU Capital Financing Program. The Department reports the corresponding liability for full payment of principal and accrued interest as a payable to the FFB.

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

- Beginning-of-the-year cash balance, collections, interest collections, disbursements, and interest payments 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. Payable to Treasury

At September 30, 2005 and 2004, Payable to the Treasury for estimated liquidating fund future cash inflows in excess of outflows and for downward re-estimates of subsidy is shown in the table below:

(Dollars in Millions)	2005	2004
Future Liquidating Account Collections, Beginning Balance	$ 3,491	$ 3,761
Valuation of Pre-1992 Loan Liability and Allowance	851	847
Capital Transfers to Treasury	(931)	(1,117)
Future Liquidating Account Collections, Ending Balance	**3,411**	**3,491**
FFEL Downward Subsidy Re-estimate	1,755	1,502
Total Payable to Treasury	**$ 5,166**	**$ 4,993**

In accordance with the *Federal Credit Reform Act of 1990*, the liquidating fund pays monies to Treasury each year based on available fund balances, and the FFEL financing fund pays the liability related to downward subsidy re-estimates upon budget execution.

Note 9. Other Liabilities

Other liabilities include current liabilities for contractual services, administrative services, deferred credits, liability for deposit funds, contingent liabilities, custodial liabilities, and the liability for unfunded accrued annual leave. Additionally, the noncurrent liabilities include accrued unfunded FECA. Other liabilities consisted of the following at September 30, 2005 and 2004:

(Dollars in Millions)	2005	2004
Intragovernmental		
Accrued Unfunded FECA Liability	$ 3	$ 3
Liability for Deposit Funds	(11)	(21)
Advances From Others	88	22
Total Intragovernmental	**80**	**4**
With the Public		
Accrued Payroll and Benefits	15	15
Accrued Unfunded Annual Leave	30	30
Custodial Liability	204	206
Deferred Credits	1	1
Liability for Deposit Funds	21	30
Other	71	99
Total With the Public	**342**	**381**
Total Other Liabilities	**$ 422**	**$ 385**

Note 10. Liabilities Not Covered by Budgetary Resources

Liabilities on the Department's Balance Sheet as of September 30, 2005 and 2004 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 consisted of the following:

(Dollars in Millions)	2005	2004
Intragovernmental		
Accrued Unfunded FECA Liability	$ 3	$ 3
Total Intragovernmental	3	3
With the Public		
Custodial Liability	204	206
Accrued Unfunded Annual Leave	30	30
Federal Employee and Veterans' Benefits	17	19
Total With the Public	251	255
Liabilities Not Covered by Budgetary Resources	**254**	**258**
Liabilities Covered by Budgetary Resources	**143,471**	**128,017**
Total Liabilities	**$ 143,725**	**$ 128,275**

Note 11. Accrued Grant Liability

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

(Dollars in Millions)	2005	2004
Federal Student Aid	$ 635	$ 637
Office of Elementary and Secondary Education	248	207
Office of Special Education and Rehabilitative Services	90	158
Office of Vocational and Adult Education	35	39
Office of Postsecondary Education	167	242
Institute of Education Sciences	70	10
Office of English Language Acquisition	20	30
Office of Safe and Drug-Free Schools	41	3
Office of Innovation and Improvement	22	35
Total Accrued Grant Liability	**$ 1,328**	**$ 1,361**

Note 12. Net Position

The nature of the Department's net position was discussed in Note 1, and the components are set forth in the Statement of Changes in Net Position. The table below reports the composition of appropriations that have not been used to fund goods and services received or benefits provided as of September 30, 2005 and 2004:

(Dollars in Millions)	2005	2004
Unobligated Balances		
Available	$ 526	$ 619
Not Available	380	280
Undelivered Orders	46,382	46,386
Total Unexpended Appropriations	**$ 47,288**	**$ 47,285**

Undelivered orders and unobligated balances for federal credit financing and liquidating funds, and trust funds are not included in the chart above because they are not funded through appropriations. As a result, unobligated and undelivered order balances in the chart above will differ from these balances in the Combined Statement of Budgetary Resources.

The Department had Cumulative Results of Operations of ($4,446) million as of September 30, 2005, and ($2,951) million as of September 30, 2004. Cumulative Results of Operations consists mostly of purchases of capitalized assets and unfunded expenses, including upward subsidy re-estimates for loan programs.

Note 13. Interest Revenue and Expense

For the Direct Loan Program, 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 Direct Loan Program, interest expense is recognized on the Department's borrowings from Treasury. For the FFEL Program, federal interest revenue is earned on the uninvested fund balance with Treasury in the financing fund. Program A, on the Statement of Net Cost, Enhancement of Postsecondary and Adult Education, includes the Direct Loan Program and the FFEL Program.

The interest revenues and expenses attributable to the Direct Loan Program, the FFEL Program, and other remaining programs are summarized below as of September 30, 2005 and 2004:

	Direct Loan Program		FFEL Program		Other Programs		Total	
(Dollars in Millions)	2005	2004	2005	2004	2005	2004	2005	2004
Interest Revenue:								
Federal	$ 1,475	$ 1,000	$ 565	$ 436	$ -	$ -	$ 2,040	$ 1,436
Non-federal	4,696	4,761	-	-	26	50	4,722	4,811
Total Interest Revenue	**$ 6,171**	**$ 5,761**	$ **565**	**$ 436**	**$ 26**	**$ 50**	**$ 6,762**	**$ 6,247**
Interest Expense:								
Federal	$ 6,171	$ 5,761	$ 565	$ 436	$ 15	$ 16	$ 6,751	$ 6,213
Non-federal	-	-	-	-	-	(3)	-	(3)
Total Interest Expense	**$ 6,171**	**$ 5,761**	$ **565**	**$ 436**	**$ 15**	**$ 13**	**$ 6,751**	**$ 6,210**

Note 14. Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. As of September 30, 2005, budgetary resources were $154,095 million and net outlays were $69,808 million. As of September 30, 2004, budgetary resources were $131,766 million and net outlays were $61,660 million.

Apportionment Categories of Obligations Incurred

The Department receives apportionments of its resources from the Office of Management and Budget (OMB). 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 OMB.

The apportionment categories of obligations incurred as of September 30, 2005 and 2004, are summarized below:

(Dollars in Millions)	2005	2004
Direct:		
Category A	$ 1,308	$ 1,279
Category B	127,489	112,970
Exempt from Apportionment	252	53
	129,049	114,302
Reimbursable:		
Category A	4	1
Category B	3	4
Exempt from Apportionment	85	86
	92	91
Total Apportionment Categories of Obligations Incurred	**$ 129,141**	**$ 114,393**

Permanent Indefinite Budget Authority

The Federal 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 of Education 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.

Unused Borrowing Authority

The Department is given authority to draw funds from the Treasury to help finance the majority of its direct lending activity. Unliquidated 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. Unused Borrowing Authority as of September 30, 2005 and 2004, was determined as follows:

(Dollars in Millions)	2005	2004
Beginning Balance, Unused Borrowing Authority	$ 5,952	$ 6,978
Current Year Borrowing Authority	32,209	22,483
Funds Drawn From Treasury	(31,309)	(21,244)
Prior Year Unused Borrowing Authority Cancelled	(1,326)	(2,265)
Other	(45)	-
Ending Balance, Unused Borrowing Authority	**$ 5,481**	**$ 5,952**

Comparison to the Budget of the United States Government

Statement of Federal Financial Accounting Standards No. 7 (SFFAS No. 7), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires an explanation of material differences between budgetary resources available, the status of those resources, and outlays as presented in the Statement of Budgetary Resources to the related actual balances published in the *Budget of the United States Government (President's Budget)*. However, the *President's Budget* has not yet been published. The *President's Budget* is scheduled for publication in February 2006 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements. There were no material differences between the Fiscal Year 2004 column on the Statement of Budgetary Resources and the fiscal year 2004 actual amounts reported in the *President's Budget*.

Note 15. 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 a decrease 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 (SFFAS No. 2), *Accounting for Direct Loans and Loan Guarantees*. Re-estimates published in the *President's Budget* generate or require resources.

Note 16. Cost and Earned Revenue by Budget Function

The Department's gross costs and revenue, by budget function for September 30, 2005 and 2004, are presented below:

(Dollars in Millions)	2005 Gross Costs	2005 Earned Revenue	2005 Net Costs	2004 Gross Costs	2004 Earned Revenue	2004 Net Costs
Education, Training Employment and Social Services	$ 82,068	$ (6,965)	$ 75,103	$ 70,062	$ (6,564)	$ 63,498
Administration of Justice	136	-	136	125	-	125
Total	**$ 82,204**	**$ (6,965)**	**$ 75,239**	**$ 70,187**	**$ (6,564)**	**$ 63,623**

The Department's intragovernmental gross costs and revenue, by budget function for September 30, 2005 and 2004, are presented below:

(Dollars in Millions)	2005 Gross Costs	2005 Earned Revenue	2005 Net Costs	2004 Gross Costs	2004 Earned Revenue	2004 Net Costs
Education, Training Employment and Social Services	$ 7,367	$ (2,221)	$ 5,146	$ 6,536	$ (1,738)	$ 4,798
Administration of Justice	136	-	136	125	-	125
Total	**$ 7,503**	**$ (2,221)**	**$ 5,282**	**$ 6,661**	**$ (1,738)**	**$ 4,923**

Note 17. Program Costs by Segment

Effective fiscal year 2006, Office of Management and Budget (OMB) Circular No. A-136 (Revised), *Financial Reporting Requirements*, changes the presentation format of the Consolidated Statement of Net Cost. Early implementation is permitted but not required for fiscal year 2005. The Department has chosen not to implement these changes and will follow the guidance provided in OMB Bulletin 01-09, *Form and Content of Agency Financial Statements.* Specifically, responsibility segments were aligned with the major goals of the Department of Education's *Strategic Plan 2002–2007*, as required by the *Government Performance and Results Act (GPRA)*.

Reporting groups were aligned with the following Strategic Goals:

- Enhance the quality and access to postsecondary and adult education,
- Create a culture of achievement,
- Improve student achievement,
- Develop safe schools and strong character, and
- Transform education into an evidence-based field.

The importance of special education was highlighted by maintaining a separate responsibility segment on the Statement of Net Cost.

Program A on the Statement of Net Cost relates directly to Strategic Goal 5: Enhance the quality of and access to postsecondary and adult education. It combines the reporting groups of Federal Student Aid, the Office of Vocational and Adult Education, and the Office of Postsecondary Education. Program B relates directly to Strategic Goals 1, 2, and 3: Create a culture of achievement, Improve student achievement, and Develop safe schools and strong character. Program B combines the Office of Elementary and Secondary Education, the Office of English Language Acquisition, and the Office of Safe and Drug-Free Schools. Program C relates to Strategic Goal 4: Transform education into an evidenced-based field, and includes the Institute of Education Sciences and Office of Innovation and Improvement. Finally, Program D relates to "special education and program execution" and includes the Office of Special Education and Rehabilitative Services.

Note 18. 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 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 latest academic year ended June 30, 2005, approximately 779,129 loans were made, totaling approximately $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.

In fiscal year 2004, the Department provided funding of 84.8 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.2 percent of program funding. For the academic year ended June 30, 2004, approximately 750,420 loans were made, totaling $1.6 billion at 1,700 institutions, averaging $2,161 per loan. The Department's share of the Perkins Loan Program was approximately $6.5 billion as of June 30, 2004.

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.

Hurricanes Katrina and Rita

On August 29, 2005, Hurricane Katrina struck the Gulf Coast, resulting in widespread catastrophic damage to the coastal regions of Louisiana, Mississippi and Alabama. Hurricane Katrina is expected to be the costliest natural disaster in U.S. history. Immediately following Katrina, Hurricane Rita struck the Gulf Coast, adding Texas to the states already catastrophically damaged and hindering 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.

To begin the reconstruction of the education process, the Department of Education has been asked by the White House to render all appropriate assistance to the region's loan applicants, students, borrowers, guaranty agencies, educational institutions and other program participants. It is impossible at this time to accurately estimate the impact of Hurricanes Katrina and Rita on the education systems, educational facilities, teachers, students, and financial institutions of the affected areas, or the demands or costs that this impact will place on the Department of Education. Any potential financial impact will relate to a future period rather than the current period.

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.