A MESSAGE FROM THE SECRETARY OF THE TREASURY

It is my privilege to issue the 2006 *Financial Report of the U.S. Government*. The objective of this report is to provide to the Congress and the American people timely, useful data on the operating costs and financial condition of the government and a discussion of the nation's long-term fiscal outlook. To make this information available early enough to inform the budget process, Treasury has issued this report on December 15 in each of the past three years rather than on the statutory deadline of March 31.

As announced in October, a strong economy and the recent surge in tax revenues has driven the budget deficit down to $248 billion, achieving the President's 2009 target of cutting the deficit in half as a percent of GDP well ahead of schedule. Consistent with the improved budget results, this report shows a lower accrual-based net operating cost of $450 billion. The improvement over 2005 results primarily from lower actuarial costs in certain agencies. There is a difference in the amounts reported for the budget deficit and the net operating cost because of the distinct methods of accounting used. The actuarial costs also account for most of the difference between the budget deficit and the net operating cost reported here.

In addition to reporting the progress in reducing the deficit, this report highlights the biggest long-term economic issue facing our country--the future claim on spending for our major entitlement programs: Medicare and Social Security. Without fundamental reform to ensure the sustainability of these programs, by the year 2080, the cost to the federal government of Social Security and Medicare together will nearly triple as a percentage of the U.S. economy, growing to 17 percent. The present value cost of net expenditures for current participants in these two programs over the next 75 years amounts to $44 trillion. These long-term challenges do not lend themselves to quick fixes, but given our expanding economy, we can approach these issues from a position of strength, and now is the time.

Treasury is committed to resolving the financial management challenges that have led to the Comptroller General of the United States being unable to express an opinion on the financial statements. These include long-standing problems at particular agencies and unique issues related to the preparation of governmentwide statements. As noted in the audit letter, progress continues to be made, but there is still much to be done to meet the highest standards of transparent, reliable financial reporting.

Through this report, we hope to inform and support the decision making so critical to the nation's fiscal future.

Henry M. Paulson, Jr.

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EXECUTIVE SUMMARY

> "We might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress and every man of any mind in the Union should be able to comprehend them, to investigate abuses, and consequently to control them."
> President Thomas Jefferson to Treasury Secretary Albert Gallatin, 1802

Financial Condition of the U.S. Government: An Overview

The *Fiscal Year 2006 Financial Report of the United States Government (Report)* provides the President, Congress, and the American people a comprehensive view of the Federal Government's finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The *Report* also discusses important financial issues and significant conditions that may affect future operations.

For the tenth consecutive year, GAO has issued a disclaimer of opinion on the consolidated financial statements. A disclaimer of opinion is not an indication of the validity or accuracy of the Government's financial information; it means that sufficient information was not available for the auditors to determine whether the information was reliable. Material weaknesses in internal control and other limitations on the scope of its work resulted in conditions that prevented GAO from forming and expressing an opinion on the Government's consolidated financial statements for the fiscal years ended September 30, 2006 and 2005. Eighteen of 24 CFO Act agencies and 24 of 31 major agencies earned unqualified opinions on their individual audits on their fiscal year 2006 financial statements.

Table 1 below provides an overview of several key indicators of the U.S. Government's financial health.

Table 1: Key Financial Indicators: FY 2004 - FY 2006

billions of dollars	2004		2005		2006	
Gross Costs	**$ 2,732.0**		**$ 3,174.6**		**$ 3,127.7**	
Less: Earned (Program) Revenue	**$ 207.1**		**$ 224.8**		**$ 226.4**	
Less: Taxes & Other Revenues:	**$ 1,912.7**		**$ 2,185.5**		**$ 2,440.8**	
Individual Income Tax		$ 1,512.3		$ 1,690.1		$ 1,846.1
Corporate Income Tax		$ 183.8		$ 271.8		$ 350.0
Other		$ 216.6		$ 223.6		$ 244.7
Net Operating Cost [1]	**$ (615.6)**		**$ (760.2)**		**$ (449.5)**	
Assets	**$ 1,397.3**		**$ 1,447.9**		**$ 1,496.5**	
Less: Liabilities, comprised of:	**$ 9,107.1**		**$ 9,914.8**		**$ 10,412.9**	
Debt to the Public		$ 4,329.3		$ 4,624.2		$ 4,867.5
Federal Employee & Veterans Benefits		$ 4,062.1		$ 4,491.8		$ 4,679.0
Other Liabilities		$ 715.7		$ 798.8		$ 866.4
Net Position (Assets Net of Liabilities)	**$ (7,709.8)**		**$ (8,466.9)**		**$ (8,916.4)**	
Social Insurance Responsibilities (off-balance sheet): [2]						
Closed Group (current participants) [3]		$ 37,279.0		$ 40,038.0		$ 44,147.0
Open Group (current + future participants) [4]		$ 33,363.0		$ 35,689.0		$ 38,851.0
Budget Results						
Budget Deficit (net of):	**$ (412.3)**		**$ (318.6)**		**$ (247.7)**	
Receipts		$ 1,879.8		$ 2,153.4		$ 2,406.7
Outlays		$ 2,292.1		$ 2,472.1		$ 2,654.4

[1] Total Net Operating Cost includes 'Unmatched Transactions and Balances' not shown in this table.

[2] present value of 75-year actuarial projections of benefit payments under current law for Social Security, Meidcare, and other social insurance programs in excess of their scheduled contributions and earmarked taxes. Not considered liabilites on the balance sheet.

[3] includes current participants (i.e., receiving and/or are eligible to receive benefits) ages 15 and over at the start of the period.

[4] includes all current and future projected participants (i.e., individuals receiving and/or are eligible to receive benefits ages 15 and over at the start of the period, PLUS participants estimated to receive and/or be eligible to receive beneifts over the 75-year horizon).

Two Sets of Books? - - Absolutely Not - - Comparing the Financial Report to the Budget Deficit

Each year, the Administration issues two reports that detail financial results for the Federal Government:

- the *President's Budget*, the Government's primary financial planning and control tool, reports "actual" budget results to inform that public that the government spent taxpayer money in accordance with applicable laws;
- the *Financial Report of the United States Government* provides the President, Congress, and the American people a broad, comprehensive overview of the cost of the Government's operations, the sources used to finance them, its balance sheet, and the outlook for its social insurance programs.

The following illustrates how the two reports complement each other.

President's Budget	Financial Report of the U.S. Government
Prepared on a '*cash basis*' • Initiative-based: focus on current and future initiatives planned and how resources *will be used* to fund them. • Receipts ('cash in'), e.g., federal income tax received, National Park fees collected. • Outlays ('cash out'), e.g., defense spending, benefit checks sent.	Prepared on an '*accrual basis*' • Retrospective: focus on how resources *have been used* to implement initiatives. • Revenue: recognized when earned, but not necessarily received.[1] • Costs: recognized when owed, but not necessarily paid.

The Financial Report has as its base ALL the transactions that form the budget results. Adjustments to convert costs and revenues from the cash basis to the accrual basis are shown in the ***Statement of Reconciliations of Net Operating Cost and Unified Budget Deficit*** in this report. The amounts itemized on this statement are intended to represent the difference between the two bases for reporting. There is no magic, no sleight of hand; just cost accruals to adjust for the timing of the cash outlay versus the portion of non cash-based cost attributable to the current period.

In 2006, for the first time, the ***Statement of Social Insurance*** has been reported and audited as a principal financial statement. The statement provides a perspective on the Government's long-term responsibilities and costs. It should be noted, however, that even with this addition, the financial statements do not reflect future costs implied by current policy, such as national defense, the global war on terrorism, and hurricane cleanup efforts.

Outstanding Revenue Growth Narrows the Gap between Costs and Revenues

As shown in Table 2, 2006 marked the third consecutive fiscal year of substantial revenue growth. A combination of solid economic growth and improved corporate tax yields have contributed to revenue growth of over 35% since 2003. In 2006, revenues grew to $2,440.8 billion establishing a new record high. Nearly $600 billion in increased cash was collected over the last three years over the $1.8 trillion base level of 2003 (an average of nearly $200 billion per year). This has contributed to a reduction of both the budget deficit and net operating cost.

Table 2: Revenue Growth: 2003-2006

billions of dollars	Total Revenue	Change from Prior Year	% Increase	Change from 2003	% Increase from 2003
2003	$ 1,796.0	$ (81.7)	-4.4%		
2004	$ 1,912.7	$ 116.7	6.5%	$ 116.7	6.5%
2005	$ 2,185.5	$ 272.8	14.3%	$ 389.5	21.7%
2006	$ 2,440.8	$ 255.3	11.7%	$ 644.8	35.9%

Costs Decline Slightly

Costs decreased to $3,127.7 billion from 2005's level of $3,174.6 billion. This is mostly made up of two contrasting items: (1) an inflationary and programmatic increase in outlays of $182 billion; and (2) a $242.5 billion reduction in actuarial costs from last year's record level of $429.7 billion to $187.2 billion in 2006, offsetting the spending increase. This unusual result stems from the methodology used to calculate the liabilities for post-

[1] Under GAAP, U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable. Exchange revenue is recognized at the time the government provides goods or services to the public or to another Government entity. Nonexchange revenue (e.g., taxes, fines, donations) is recognized to the extent that the collection is probable and the amount is measurable.

employment benefit programs such as employee pensions, health, and veteran's compensation. Actuarial calculations of future outlays by year for these programs are made; then all years are discounted back to the present. Interest rate levels are among the most significant assumptions about the future that can impact these estimates.

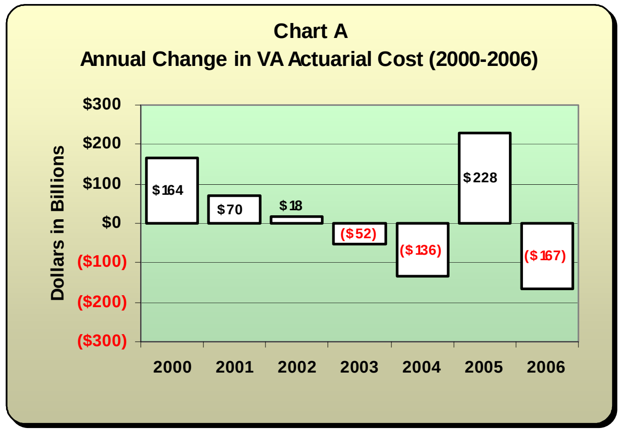


Chart A shows the fluctuation in VA's actuarial costs over the past several years. Interest rate changes have a significant role in these variations. VA reported a substantial decrease in actuarial costs (calculated as the annual change in actuarial liabilities) of $166.6 billion. This followed both significant actuarial cost increases and decreases in 2005 and 2004, respectively. These fluctuations stem mainly from the use of interest rates at year-end to discount future benefits and estimate a current liability amount. Most federal actuarial liabilities are calculated through the use of average future interest rates, not spot rates as of September 30th of the current period. Because a small change in interest rate assumptions produces the large actuarial cost fluctuations shown in Chart A, reported annual VA actuarial costs are not useful in predicting future annual costs. The change in VA's actuarial costs from year to year accounts for the majority of the change in the Government's net cost in most years (54 percent in 2006). Moreover, in 2006, the change in these and other actuarial (e.g., pension) costs accounted for nearly 80 percent of the $310 billion decrease in total net operating cost. Finally, total actuarial costs in 2006 of $187.2 billion, as in most recent years, account for most of the annual differences (93 percent in 2006) between the Government's budget deficit and net cost, and ostensibly, between the cash and accrual bases of accounting in the Federal Government.

Assets & Liabilities – What We Own and What We Owe

The Government's year-end net position can be derived by netting its assets against its liabilities on the ***Balance Sheet***. It is important to note that the balance sheet excludes the financial impact of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. Moreover, the Government's responsibilities are broader than the liabilities presented on the balance sheet, including its future social insurance responsibilities (e.g., Social Security and Medicare), as well as other programs and contingencies.

The Government's largest liability has been the Federal debt held by the public and accrued interest, which increased $243.3 billion to $4,867.5 billion in fiscal year 2006 from $4,624.2 billion in 2005. The sharp increase in tax revenues enabled the Government to borrow a smaller amount of cash from the public this year as compared to the previous year to finance its operations. The Government increased its net borrowings from the public by a combined $529.5 billion since fiscal year 2005 to help finance more than 90 percent of budget deficits in both 2005 and 2006. However, the Government's debt operations are much more complex than this would imply. Each year, trillions of dollars of debt matures and new debt takes its place. For example, in fiscal year 2006, new borrowings were $4.5 trillion and maturing debts were $4.2 trillion.

Federal employee and veteran benefits payable, 45% of the Government's total reported liabilities, have increased dramatically in recent years, from $2,600.7 billion at fiscal year-end 1999, to $4,679.0 billion as of September 30, 2006.

Social Insurance and Other Responsibilities

Information reported on social insurance programs addresses fundamental questions about their current and future financial sustainability, i.e., the extent to which the Government could meet future program demands under current laws and conditions. For the programs listed as social insurance (e.g., Old Age, Survivors' and Disability Insurance (OASDI) or Social Security, Medicare (Parts A, B, and D)), the Statement of Social Insurance (SOSI) shows the estimated future excess of scheduled benefit expenses over contributions, premiums, and tax income (excluding interest), based on each program's actuarial trust fund report (see Table 3).

In concert with other financial statements and reports, this information gives both a short- and long-term view of significant financial issues facing the Government. For financial reporting purposes, the ***Balance Sheet*** presents a 'snapshot' at a point in time of the Government's *current* financial condition, emphasizing how current and prior actions and events have impacted its assets and liabilities. By contrast, the ***SOSI*** presents an assessment of the extent to which the programs are unfunded under current financing arrangements relative to scheduled benefit obligations, based on the calculated net present value of future estimated revenues and expenditures over an extended period.

Table 3: Social Insurance Responsibilities

billions of dollars	2002	2003	2004	2005	2006
This table shows the present value of 75-year actuarial projections of the benefit payments under current law for Social Security, Meidcare, and other social insurance programs in excess of their scheduled contributions and earmarked taxes for current participants ages 15 and over at the start of the period.					
Social Insurance Responsibilities, Net (closed group) [1]					
Social Security (OASDI)	$ (11,216)	$ (11,742)	$ (12,552)	$ (13,583)	$ (14,976)
Medicare	$ (12,896)	$ (15,007)	$ (24,615)	$ (26,339)	$ (29,040)
Other [2]	$ (107)	$ (109)	$ (112)	$ (116)	$ (131)
Total Social Insurance Responsibilities, Net, (closed group)	**$ (24,219)**	**$ (26,858)**	**$ (37,279)**	**$ (40,038)**	**$ (44,147)**
Total Social Insurance, Net (open group) [2]	**$ (17,887)**	**$ (20,825)**	**$ (33,363)**	**$ (35,689)**	**$ (38,851)**

[1] The 'closed group' includes current participants (i.e., receiving and/or are eligible to receive benefits) ages 15 and over at the start of the period. The 'open' group' (shown below for comparative purposes), includes all current and future projected participants (i.e., individuals receiving and/or are eligible to receive benefits ages 15 and over at the start of the period, PLUS participants estimated to receive and/or be eligible to receive beneifts in the future over the 75-year horizon).

[2] For the 'closed' group, 'Other Social Insurance Programs' = Railroad Retirement Program. The 'open' group includes both the Railroad Retirement and Black Lung Programs. The SOSI presents only 'open group' totals for Black Lung (i.e., does not identify 'closed' group amounts separately). Therefore, Black Lung is only reflected in the 'open' group amounts above.

Since these estimates are not liabilities, and therefore do not impact either an entity's current assets or liabilities, they are considered 'off-balance sheet' items; according to Federal accounting standards. This distinction substantially limits the comparability of the Government's current net liabilities to future net social insurance responsibilities. Their significance can, however, be measured in other contexts. Table 4 shows how the two compare. Fiscal year 2006 total assets of $1,496.5 billion and total liabilities of $10,412.9 billion combine to derive the Government's current net liability of $8,916.4 billion. By comparison, SOSI reports net present value expenditures of $44,147 billion in net social insurance responsibilities. [2] The net social insurance responsibilities (scheduled benefits in excess of estimated revenues) indicate that those programs are on an unsustainable fiscal path and difficult choices will be necessary in order to address their large and growing long-term fiscal imbalance. Delay is costly and choices will be more difficult as the retirement of the 'baby boom' gets closer to becoming a reality with the first wave of boomers eligible for retirement under Social Security in 2008

Table 4. Comparing Current Net Liabilities to Future Social Insurance Responsibilities

billions of dollars	2002	2003	2004	2005	2006
Liabilities Net of Assets (balance sheet)	$ (6,820)	$ (7,094)	$ (7,710)	$ (8,467)	$ (8,916)
	The balance sheet presents a 'snapshot' of an entity's **current** financial position (net of assets and liabilities as of the end of the current fiscal year.				
Social Insurance Responsibilities, Net (closed group - - off-balance sheet)	$ (24,219)	$ (26,858)	$ (37,279)	$ (40,038)	$ (44,147)
	The Statement of Social Insurance presents the present value of estimated **future** revenues and expenditures under current law.				
Combined Net Liabilities (current) and Social Insurance Responsibilities (future)	**$ (31,039)**	**$ (33,952)**	**$ (44,989)**	**$ (48,505)**	**$ (53,063)**

Looking Ahead – The President's Management Agenda

Fiscal responsibility requires the sound stewardship of taxpayer money. Once the Congress and the President decide on overall spending levels, taxpayer dollars should be managed to maximize results. The President's Management Agenda (PMA) is creating a results-oriented Government where agencies and programs are managed professionally and efficiently to achieve the results expected by the Congress and the American people.

The PMA's broad goal is to make the Government more results-oriented with a focus on achievement, efficiency, and accountability. It emphasizes improving Government operations by setting clear goals and action plans, and then following through on those plans. Agencies continue to manage to achieve better results. PMA standards for success are used to measure agencies' progress and achievement in meeting overall goals. The chart above summarizes Federal agencies' current status as of September 30, 2006. Agencies are also rated on their progress. These ratings and other related information are discussed later in this report and are available at: www.whitehouse.gov/results/agenda/standards.pdf

[2] Tables 3 and 4 both focus on closed-group obligations, equal to the present value of net payments (benefits less taxes) expected during the projection period on behalf of program participants over age 15 at the start of the projection period. While a true accrual measure would count only benefits already earned (and taxes already paid) by current workers, the closed-group liability includes future benefit accruals and future taxes of current workers, making the closed-group numbers more forward-looking than a strict accrual-based calculation.

MANAGEMENT’S DISCUSSION AND ANALYSIS

Introduction

The *2006 Financial Report of the United States Government (Report)* provides the President, Congress, and the American people a comprehensive view of the Federal Government’s finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The *Report* also discusses important financial issues and significant conditions that may affect future operations.

Pursuant to 31 U.S.C. § 331(e)(1), the Department of the Treasury must submit the *Financial Report*, which is subject to audit by the Government Accountability Office (GAO), to Congress no later than six months after the September 30 fiscal year-end. In order to encourage more timely and relevant reporting, the Office of Management and Budget (OMB) accelerated both the individual agency and governmentwide reporting deadlines to 45 days and 75 days after year-end, respectively, beginning with fiscal year 2004 reporting cycle.

For each of the past ten years, GAO has issued a disclaimer of opinion on the consolidated financial statements. A ‘disclaimer’ means that sufficient information was not available for the auditors to determine whether the information was reliable. Material weaknesses in internal control and other scope limitations resulted in conditions that prevented GAO from forming and expressing an opinion on the Government’s consolidated financial statements for the fiscal years ended September 30, 2006 and 2005. However, eighteen of the 24 most significant Federal agencies earned unqualified opinions on their FY 2006 financial statement audits. Table 5 summarizes agency audit results.

Table 5
FY 2006 Agency Audit Results

Unqualified			Qualified	Disclaimer
USDA	Treasury	SBA	Energy [1]	Defense
Commerce	VA	SSA	Transportation	DHS [2]
Education	USAID	Ex/Im Bank	Smithsonian[3]	State
HHS	EPA	FCC		NASA
HUD	GSA	PBGC		
Interior	NSF	RRB		
Justice	NRC	SEC		
Labor	OPM	USPS		

[1] Balance Sheet Audit Only
[2] Balance Sheet and Custodial Statement Audit Only
[3] GFRS Audit Only

The fiscal year 2006 *Financial Report* consists of:

- Management’s Discussion and Analysis (MD&A), which provides management’s perspectives on and analysis of information presented in the report, such as financial and performance trends;
- The principal financial statements and the related footnotes to the financial statements;
- Stewardship and Supplemental Information; and
- GAO’s Audit Report.

FY 2006 marks the first year that agencies’ Statements of Social Insurance (SOSI) have been audited as a separate, principal statement. These statements are based on the Trustee Reports for such programs as Social Security and Medicare. All agencies reporting on the SOSI earned unqualified opinions on their FY 2006 audits.

Mission & Organization

The Government’s fundamental mission is derived from the original mission in the Constitution*: **“…to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity.”*** The Congress authorizes and agencies implement new or changed programs as missions and initiatives evolve over time in pursuit of key public services and objectives, such as providing for national defense promoting health care, fostering income security, boosting agricultural productivity, providing veteran benefits and services, facilitating commerce, supporting housing and the transportation systems, protecting the environment, contributing to the security of energy resources, and helping States provide education. The following chart provides an abbreviated overview of how the U.S. Government is organized.

THE UNITED STATES GOVERNMENT

THE CONSTITUTION

LEGISLATIVE BRANCH

THE CONGRESS
SENATE HOUSE

Architect of the Capitol
United States Botanic Garden
Government Accountability Office
Government Printing Office
Library of Congress
Congressional Budget Office

EXECUTIVE BRANCH

THE PRESIDENT
THE VICE PRESIDENT
EXECUTIVE OFFICE OF THE PRESIDENT

White House Office
Office of the Vice President
Council of Economic Advisers
Council on Environmental Quality
National Security Council
Office of Administration
Office of Management and Budget
Office of National Drug Control Policy
Office of Policy Development
Office of Science and Technology Policy
Office of the U.S. Trade Representative

JUDICIAL BRANCH

THE SUPREME COURT OF THE UNITED STATES

United States Courts of Appeals
United States District Courts
Territorial Courts
United States Court of International Trade
United States Court of Federal Claims
United States Court of Appeals for the Armed Forces
United States Tax Court
United States Court of Appeals for Veterans Claims
Administrative Office of the United States Courts
Federal Judicial Center
United States Sentencing Commission

DEPARTMENT OF AGRICULTURE *
DEPARTMENT OF COMMERCE *
DEPARTMENT OF DEFENSE *
DEPARTMENT OF EDUCATION *
DEPARTMENT OF ENERGY *
DEPARTMENT OF HEALTH AND HUMAN SERVICES *
DEPARTMENT OF HOMELAND SECURITY *
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT *
DEPARTMENT OF THE INTERIOR *
DEPARTMENT OF JUSTICE *
DEPARTMENT OF LABOR *
DEPARTMENT OF STATE *
DEPARTMENT OF TRANSPORTATION *
DEPARTMENT OF THE TREASURY *
DEPARTMENT OF VETERANS AFFAIRS *

INDEPENDENT ESTABLISHMENTS AND GOVERNMENT CORPORATIONS

African Development Foundation
Broadcasting Board of Governors
Central Intelligence Agency
Commodity Futures Trading Commission
Consumer Product Safety Commission
Corporation for National and Community Service
Defense Nuclear Facilities Safety Board
Environmental Protection Agency *
Equal Employment Opportunity Commission
Export-Import Bank of the U.S. *
Farm Credit System Insurance Corporation *
Federal Communications Commission *
Federal Deposit Insurance Corporation *
Federal Election Commission
Federal Housing Finance Board
Federal Labor Relations Authority
Federal Maritime Commission
Federal Mediation and Conciliation Service
Federal Mine Safety and Health Review Commission
Federal Reserve System
Federal Retirement Thrift Investment Board
Federal Trade Commission
General Services Administration *
Inter-American Foundation
Merit Systems Protection Board
National Aeronautics and Space Administration *
National Archives and Records Administration
National Capital Planning Commission
National Credit Union Administration *
National Foundation on the Arts and the Humanities
National Labor Relations Board
National Mediation Board
National Railroad Passenger Corporation (Amtrak)
National Science Foundation *
National Transportation Safety Board
Nuclear Regulatory Commission *
Occupational Safety and Health Review Commission
Office of the Director of National Intelligence
Office of Government Ethics
Office of Personnel Management *
Office of Special Counsel
Overseas Private Investment Corporation
Peace Corps
Pension Benefit Guaranty Corporation *
Postal Rate Commission
Railroad Retirement Board *
Securities and Exchange Commission *
Selective Service System
Small Business Administration *
Social Security Administration *
Tennessee Valley Authority *
Trade and Development Agency
U.S. Agency for International Development *
U.S. Commission on Civil Rights
U.S. International Trade Commission
U.S. Postal Service *

*Indicates a significant entity included in the *Financial Report*.
Original source: *U.S. Government Manual 2005/2006*

Economy, Federal Budget, & Federal Debt

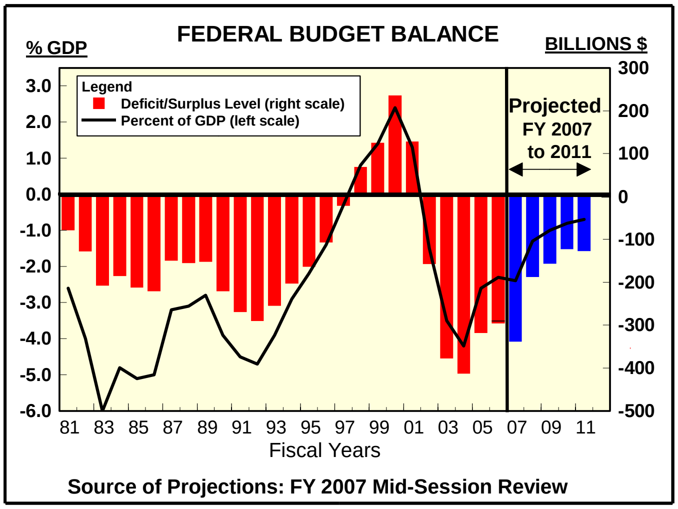
Growth in the U.S. economy remained favorable and well balanced through fiscal year 2006. Real GDP and real hourly compensation increased, job creation was solid, and the unemployment rate averaged 4.7 percent, down from 5.2 percent in the previous year. Productivity growth continued through 2005 to the first half of 2006. The deficit outlook through 2012 is for steady deficit declines due to a growing economy, tight controls on discretionary spending, and continued strong economic growth.

The Economy in Fiscal 2006

After rising at an annual average rate of 3.2 percent over the four quarters of 2005, growth in real GDP continued to increase through the first three quarters of 2006 - - rising at annual rates of 5.6 percent in the first quarter of the year; 2.6 percent in the second quarter; and 2.2 percent in the third quarter of 2006. Holding growth down in the third quarter was a sharp 18.0 percent annual rate decrease in residential fixed investment, extending a string of declines to four quarters in this sector as housing demand weakened. The quarterly pattern of GDP growth and consumer spending in 2005 and 2006 was also affected by last fall's hurricanes. Consumer spending growth averaged a 3.6 percent annual rate in the first three quarters of 2005 before slowing to 0.8 percent in the fourth quarter. Consumer spending rebounded in the first three quarters of 2006, rising 4.8 percent in the first quarter, 2.6 percent in the second, and accelerating to 2.9 percent in the third for an average rate of 3.4 percent over that period. In the third quarter of 2006, consumer spending on durable goods picked up to a 6.0 percent annual rate in the third quarter as purchases of motor vehicles moved higher and contributed 0.29 percentage points to real GDP growth.

Outside of residential building, fixed investment was strong. Real investment in equipment and software expanded by an average of 7.0 percent in the four quarters of 2005 followed by a 15.6 percent hike in the first quarter of 2006, a 1.4 percent decline in the second quarter, and a 7.2 percent increase in the third -- for an average of 7.1 percent over the three quarters of 2006. Investment in nonresidential structures shot up at a 12.0 percent annual rate in the final quarter of 2005 and rose at annual rates of 8.7 percent in the first quarter of 2006, 20.3 percent in the second quarter, and 16.7 percent in the third for an average pace of 15.2 percent over the three quarters -- the largest gain for this sector since a 24.7 percent spike in the second quarter of 1994. Labor markets continue to be robust. Nonfarm payroll employment expanded at an average rate of 147,000 jobs per month through the first ten months of 2006, and since the employment trough of August 2003, the economy has created more than 6.0 million new jobs.

An upcoming benchmark revision announced by the Bureau of Labor Statistics will be incorporated into the jobs totals next February, and may imply that the economy has actually generated closer to 7 million jobs since August 2003 or about 180,000 per month. The unemployment rate declined to 4.6 percent in September 2006 from 4.7 percent in the previous month, and dipped further to 4.4 percent in October. Core inflation remains relatively benign. Inflation rose in the first three quarters of the year, but appears contained. The overall consumer price index (CPI) fell 0.5 percent in September and October as energy prices turned down. The "core" CPI (excluding food and energy) was up 2.7 percent in the year ending September 30, 2006.



Budget Results

The deficit improved in fiscal year 2006. Receipts totaled $2,407 billion, up $253.4 billion from a year earlier. Increases in receipts are the main reason the deficit picture has improved, with growth in receipts fueled by increased employment and corporate profits, which contributed to growth in both individual income tax revenue and in corporate tax revenue Outlays rose to $2,654 billion, $182 billion more than last year. The deficit in 2006 came in at $248 billion, $71 billion less than the deficit in 2005.

Federal Debt

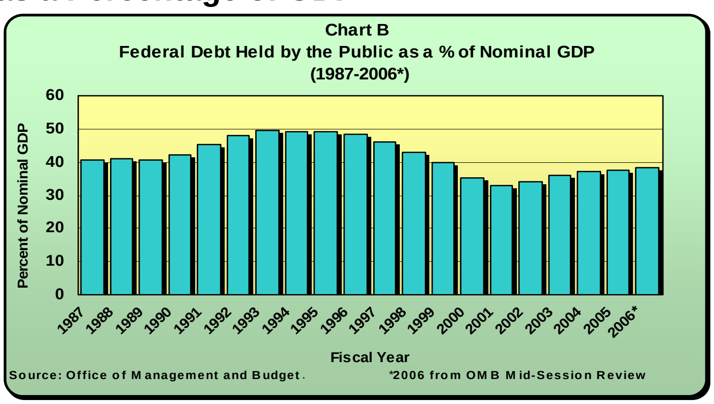
There are two kinds of Federal debt: debt held by the public and intragovernmental debt (i.e., debt the Government owes to itself). At the end of fiscal year 2006, the total of these two kinds of debt was $8,529.6 billion. Debt held by (or owed to) the public is included as a liability on the balance sheet and includes all Treasury securities (bills, notes, bonds, inflation-protected, and other securities) held by individuals, corporations, Federal Reserve banks, foreign governments, and other entities outside the.Government. Intra-governmental debt is primarily held in the form of special nonmarketable securities by various parts of the Government. The laws establishing Government trust funds generally require the excess trust fund receipts to be invested in these special securities. This debt is not included on the balance sheet because these payments are claims of one part of the Government against another and are eliminated for consolidation purposes (see Financial Statement Note # 10).

Federal debt is subject to a statutory ceiling known as the debt limit. Prior to 1917, the Congress approved each issuance of debt. In 1917, to facilitate planning in World War I, the law established a dollar ceiling for Federal borrowing, which has been periodically increased over the years. On March 20, 2006, legislation became effective raising the current limit from $8,184.0 billion to $8,965.0 billion. Gross debt, excluding some adjustments, is the measure subject to the Federal debt limit. At the end of fiscal year 2006, the amount of debt subject to the limit was $8,420.3 billion, leaving a margin of $544.7 billion until the debt ceiling is reached.

How the Federal Budget is related to the Federal Debt

The budget surplus or deficit is the difference between total Federal spending and receipts in a given year. The Government borrows from the public to finance a budget deficit. A budget surplus occurs when the Government accumulates excess funds that are used to reduce debt held by the public. In other words, deficits or surpluses are related to the annual net change in the amount of debt held by the public, while the debt held by the public generally represents the total of all cash-based deficits minus all cash-based surpluses built up over time.

Federal Debt Held by the Public as a Percentage of GDP



The Federal debt held by the public as a share of GDP reflects how much of the Nation's wealth is absorbed by the Federal Government to finance its obligations. Chart B shows the Debt/GDP ratio trend from 1987 through 2006. Starting in the late 1970s, increasing budget deficits spurred a corresponding increase in debt held by the public, which essentially doubled as a share of GDP over a 15-year period throughout the mid-1990s and reached about 50 percent in 1993. The budget controls instituted by the Congress and the President, together with economic growth, contributed to the budget surpluses at the end of the 1990s. These surpluses led to a decline in the debt held by the public, and from fiscal years 1998 through 2001, the debt-to-GDP measure declined from about 43 percent to about 33 percent. In fiscal years 2002 through 2004, the debt-to-GDP ratio started to rise slightly, due to many factors, including increased spending for homeland security and defense commitments, the decline in receipts owing to the recession and lower stock market value, as well as tax cuts, and the expiration of the budget controls that once helped instill spending discipline. The ratio has increased each year since 2001, but has risen only slightly since 2004 to 37.6 percent in 2006, still far below the roughly 50 percent ratio of the mid-1990s.

Financial Condition and Results of Operations

This *Report* provides the results of the Government's financial operations, including its financial condition, revenues and costs, assets and liabilities, and other obligations and commitments. This information, when combined with the President's Budget, collectively provides a valuable tool for managing current operations and planning future initiatives.

Accrual-Based Results and Basis of Accounting

Each year, the Administration issues two reports that detail financial results for the Federal Government: the *President's Budget*, whose main purpose is to provide a prospective discussion of future initiatives and the resources needed to support them; and this *Financial Report*, which provides the President, Congress, and the American people a broad, comprehensive overview of the cost of the Government's operations, the sources used to finance them, its balance sheet, and the outlook for its social insurance programs.

President's Budget	Financial Report of the U.S. Government
Prepared on a '*cash basis*' • Initiative-based: focus on current and future initiatives planned and how resources *will be used* to fund them. • Receipts ('cash in'), e.g federal income tax received, National Park fees collected , • Outlays ('cash out'), e.g., defense spending, benefit checks sent.	Prepared on an '*accrual basis*' • Retrospective – prior and present resources used to implement initiatives. • Revenue: recognized when earned, but not necessarily received. • Costs: recognized when owed, but not necessarily paid.

Treasury prepares the financial statements in this *Report* primarily on an accrual basis of accounting (i.e., recognizing revenues when earned, not received; and costs when incurred, not paid) as prescribed by U. S. generally accepted accounting principles (GAAP) for Federal entities.[1] These standards are tailored to the Government's unique characteristics and circumstances. For example, agencies prepare a uniquely structured 'Statement of Net Cost,' which is intended to present net Government resources used in its operations, instead of an 'Income Statement,' which private sector companies typically use to focus on profits earned. Also unique to Government is the preparation of separate statements, to reconcile differences and articulate the relationship between budget and accrual accounting results (e.g., Statement of Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Deficit).

Reporting Entity

These financial statements cover the three branches of the Government (legislative, executive, judicial). Legislative and judicial branch reporting focuses primarily on budgetary activity. Only executive branch entities are required, by law to prepare audited financial statements. Some legislative branch entities do, however, voluntarily submit financial reports.

A number of Government entities and organizations are excluded due to the nature of their operations, including the Federal Reserve System (an independent entity that serves both public and private purposes); the Federal Retirement Thrift Investment Board; fiduciary funds owned by Federal employees; and government-sponsored but privately-owned enterprises, including the Federal Home Loan Banks, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. A list of the significant agencies and entities contributing to this report is included in the Appendices.

Limitations of the Financial Statements

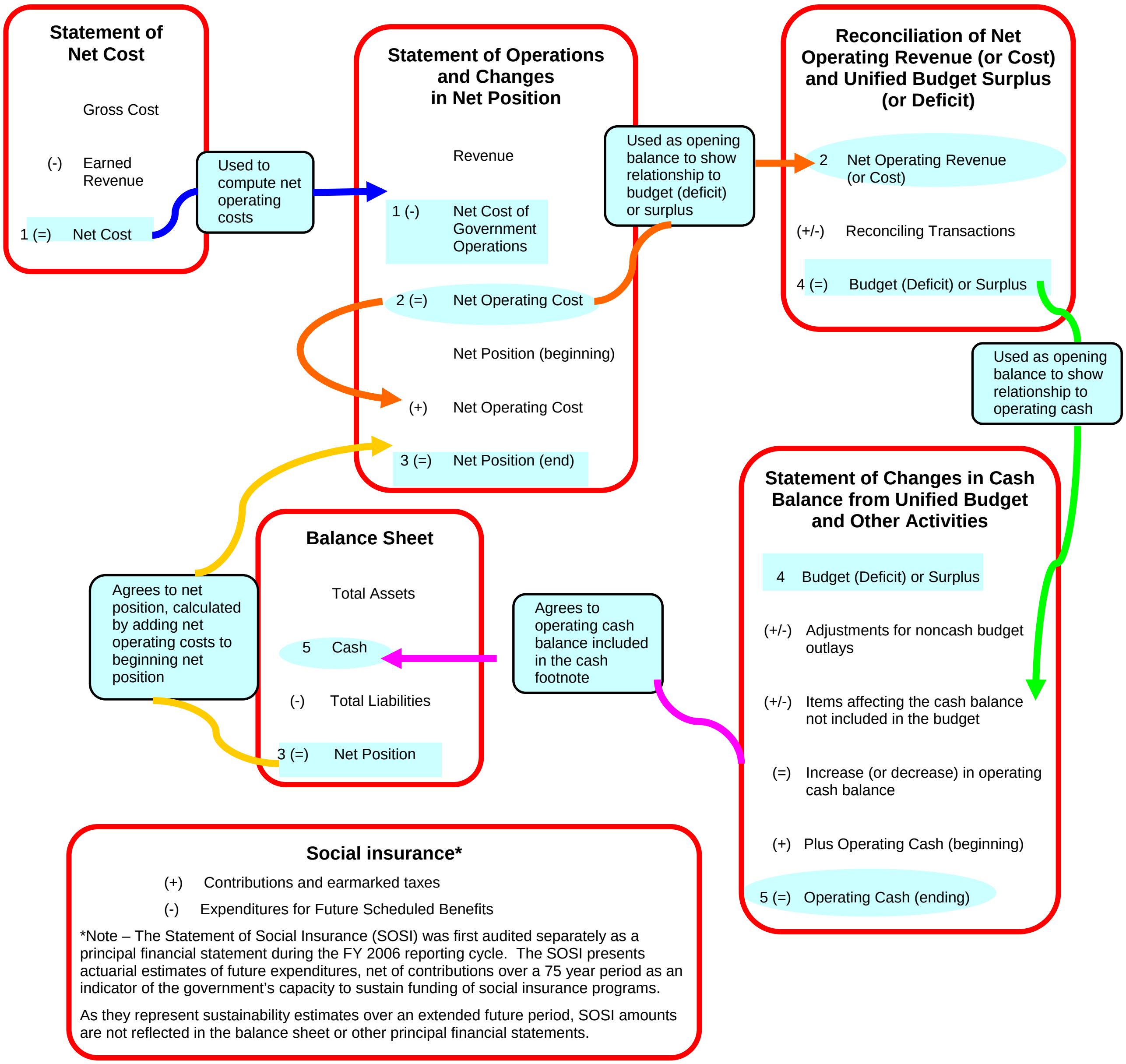
The principal financial statements have been prepared to report the financial position and results of operations of the Federal Government, pursuant to the requirements of 31 U.S.C. § 331(e)(1). While the statements have been prepared from the books and records of the entity in accordance with U.S. GAAP for Federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

[1] Under GAAP, U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable.

How the Federal Government's Financial Statements are Related to Each Other

The Government's financial statements share relationships that, in combination, provide a comprehensive, integrated view of the Nation's finances. The following graphic illustrates these relationships.

How the Federal Government's Financial Statements are Related to Each Other



Notes

1 The total operating expense, called Net Cost, presented in the Statement of Net Cost is used in the Statement of Operations and Changes in Net Position to determine whether the Federal Government's financial operations (revenue less expenses) resulted in net operating cost or net operating revenue for the year.

2 The operating result from the Statement of Operations and Changes in Net Position explains the change in the Federal Government's net position. It is also the beginning balance in the Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit).

3 The Net Position from the Statement of Operations and Changes in Net Position agrees to the Net Position on the Balance Sheet, which is based on the difference between the Federal Government's reported assets and liabilities.

4 The unified budget result is used in the Reconciliation of Net Operating Revenue (or Cost) and Unified Budget Surplus (or Deficit) and the Statement of Changes in Cash Balance from Unified Budget and Other Activities to show how the Federal Government's financial operations and changes in operating cash are connected to the unified budget results.

5 The Federal Government's ending operating cash balance from the Statement of Changes in Cash Balance from Unified Budget and Other Activities is the same as the operating cash component of the "Cash and other monetary assets" line on the Balance Sheet. The operating cash amount can be found in the Balance Sheet note for Cash and other monetary assets.

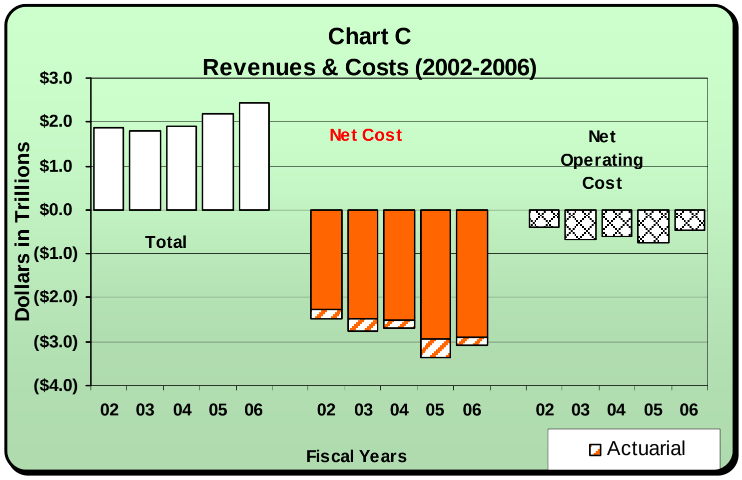
Source: Government Accountability Office.

Determining the Government's Net Position: "Where We Are"

The Government's financial position and condition have traditionally been expressed through the Budget, focusing on the impact of surpluses and deficits. However, this primarily cash-based discussion of the Government's net outlays (deficit) or net receipts (surplus), tells only part of the story. The Government's net position is driven simultaneously by the Government's revenues and expenses, as well as the changes in its assets and liabilities.

Revenues and Costs: What Came In & What Went Out

The Government's ***Statement of Operations and Changes in Net Position***, much like a corporation's income statement, shows the Government's 'bottom line' (i.e., its net revenues and costs). Chart C shows that the Government has incurred a total net operating cost (i.e., costs have exceeded its revenues) over the past several years. In 2006, net operating costs decreased more than 40 percent from $760.2 billion in fiscal year 2005 to $449.5 billion. 2006 net operating costs accounted for the 5.3 decrease in net position from $8,466.9 billion to $8,916.4 billion during the year. The Government last generated net operating revenue (i.e., revenues exceeded costs) in fiscal years 1999 and 2000 in the amounts of $101.3 billion and $39.6 billion, respectively, in concert with the budget surplus. Since then, the government has incurred average net operating costs of $562.1 billion per year.



The Government nets its costs against both earned revenues from Government programs (e.g., Medicare premiums, national park entry fees) and taxes and other revenue. Taxes account for the vast majority of total revenues. The government's 'bottom line' is its net operating cost, or those costs that cannot be supported by earned, program revenue. Table 6 illustrates the derivation of the government's net cost and net operating cost for 2004, 2005, and 2006. The Government must finance any costs as they are paid that cannot be covered by revenues with federal debt, subject to the statutory debt limit. Beginning in fiscal year 2006, the ***Statement of Operations and Changes in Net Position*** identifies resources that have been earmarked for specific activities or operations.

Net operating costs are comparable, but not identical, to the budget deficit. The ***Reconciliation of Net Operating Cost and Unified Budget Deficit Statement*** shows how the government's net operating cost relates to the more widely-known budget deficit. As indicated in Table 7, the main differences between the two for fiscal years 2005 and 2006 are:

Table 6: Net Cost of the Federal Government

billions of dollars	2004	2005	2006
Gross Costs:			
HHS	$ 583.9	$ 623.4	$ 678.8
DoD	$ 672.1	$ 703.9	$ 658.0
SSA	$ 534.9	$ 572.1	$ 593.1
Interest on Federal Debt	$ 158.3	$ 181.2	$ 221.5
VA	$ 51.1	$ 276.6	$ 117.3
Other Federal Agencies	$ 731.7	$ 817.4	$ 859.0
Total Gross Costs	**$ 2,732.0**	**$ 3,174.6**	**$ 3,127.7**
Less: Earned Revenue (revenue generated by programs)	(207.1)	(224.8)	(226.4)
Net Cost	**$ 2,524.9**	**$ 2,949.8**	**$ 2,901.3**
Less: Taxes & Other Revenue	1,912.7	2,185.5	2,440.8
Total Net Operating Cost[1]	**$ 615.6**	**$ 760.3**	**$ 449.5**

[1]Total Net Operating Cost includes 'Unmatched Transactions and Balances ' not shown in this table.

- changes in actuarial expenses related to employee and veteran benefits are included in net operating cost, but not in the budget deficit;
- purchases of capitalized fixed assets are included in the budget deficit (recorded in the year outlay(s) are made), but not in net operating cost, offset by depreciation over the life of the asset.

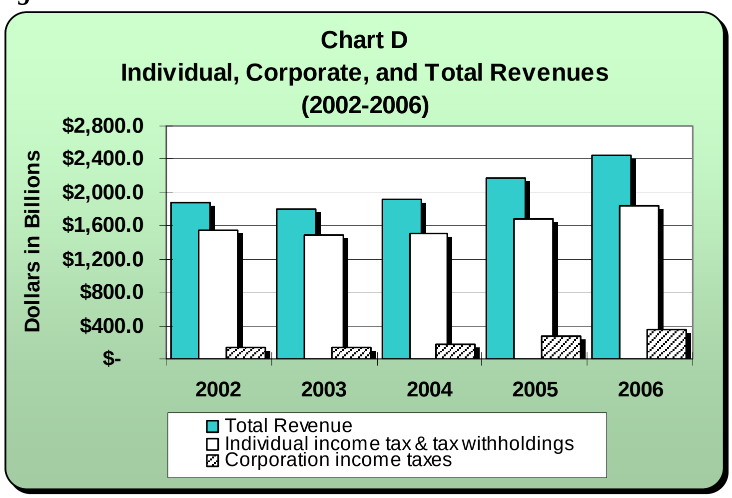
Table 7: How Net Operating Cost Relates to the Budget Deficit			
billions of dollars	2004	2005	2006
Total Net Operating Cost	**$ 615.6**	**$ 760.3**	**$ 449.5**
Net Change: Federal Employee and Military Benefit Liabilities	(212.1)	(232.0)	(156.0)
Net Change in Veterans Benefits Liabilities	30.0	(197.8)	(31.2)
Net Change - Other Costs	(21.2)	(11.9)	(14.6)
Budget Deficit	**$ 412.3**	**$ 317.6**	**$ 247.7**

As noted earlier, Treasury primarily uses the 'accrual method' of accounting in preparing the Government's financial statements, recognizing revenues when earned, not collected, and costs when incurred, not paid. Chart C shows that the Government's total net cost includes an 'actuarial' element (e.g., the present value of an employer's expected long-term cost of paying postemployment pension benefits that have been earned by the employee at the time the employee is eligible). Changes in assumptions used to project actuarial costs, such as interest rates and VA's annual estimates of veterans compensation and burial benefits can cause those projections, and consequently total costs, to fluctuate year to year. Further, these actuarial costs, in recent years, have accounted for the vast majority of the difference between the primarily cash-based budget and the primarily accrual-based financial reports. Chart C shows the impact that actuarial costs have on total costs.

Revenue: "What Came In"

The ***Statement of Net Costs*** reports 'earned' revenue generated by Federal programs. In fiscal year 2006, the Government's total earned revenues increased $1.6 billion to $226.4 billion. Nearly one-fourth of these revenues are attributable to Medicare premiums paid by program participants.

The ***Statement of Operations and Changes in Net Position*** shows the Government's taxes and other revenues (i.e.., revenues other than 'earned'). Fiscal year 2006 marked the third consecutive year of substantial revenue growth. A combination of solid economic growth and improved corporate tax yields have contributed to revenue growth of over 35 percent since 2003. Personal income and corporate profits before tax rose 6.3 percent and 14.1 percent, respectively in 2006 [2], and have increased by an average of 5.0 percent and 16.4 percent per year, respectively, since fiscal year 2001, including revenue decreases in 2001and 2002. These trends, in part, contributed to an increase in taxes and other revenues for 2006 of $255.3 billion to $2,440.8 billion, establishing a new record high. Chart D shows that individual and corporate income tax revenues, which increased 9.2 percent and 28.8 percent, respectively during 2006, account for the majority (nearly 90 percent) of total revenues. Similarly, nearly $600 billion in increased cash was collected over the last three years over the $1.8 trillion base level of 2003 (an average of nearly $200 billion per year). This recent growth in revenues has contributed to a reduction of both the budget deficit and net operating cost.



Cost: "What Went Out."

The ***Statement of Net Cost*** shows how much it costs to operate the Federal Government, recognizing expenses when they happen, regardless of when payment is made (accrual basis). It shows the derivation of the Government's net cost of operations or the difference between costs of goods produced and services rendered by the Government during the fiscal year, and the corresponding earned revenues, as described above. This amount, in turn, is offset

[2] Personal income and corporate profit statistics sources: National Income and Products Account Tables, Bureau of Economic Analysis, Department of Commerce.

against the Government's taxes and other revenue in the ***Statement of Operations and Changes in Net Position*** to calculate the 'bottom line' or net operating costs.

In fiscal year 2006, the Government's total gross cost decreased $46.9 billion to $3,127.7 billion. Offsetting gross cost against the $226.4 billion in earned revenue described earlier yields a total net cost of operations of $2,901.3 billion. Further reducing this amount by the $2,440.8 billion in taxes and other revenues results in the Government's 'bottom line' accrual net operating cost of $449.5 billion, a decrease of more than $300 billion (more than 40 percent) from 2005 net operating costs of $760.2 billion.

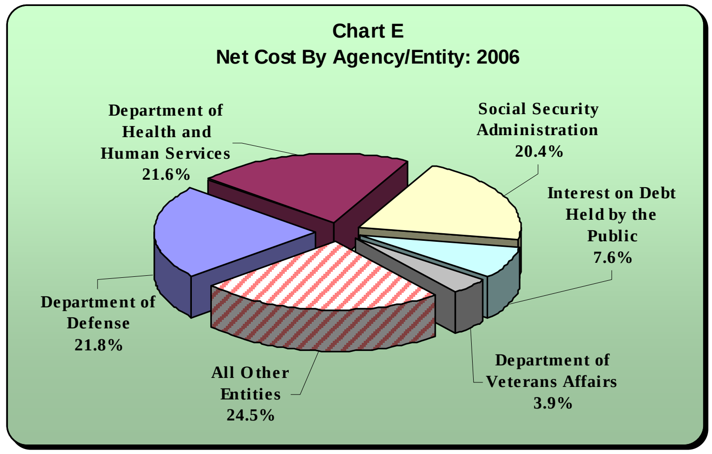


Chart E
Net Cost By Agency/Entity: 2006

Chart E shows that, along with interest on debt held by the public, the source of over three-quarters of the Government's fiscal year 2006 net cost of operations comes from four Federal entities: the Departments of Defense (DoD) and Health and Human Services (HHS), the Social Security Administration (SSA), and the Department of Veterans Affairs (VA). Chart F shows that DoD has incurred the largest agency share of the Government's total net cost of operations in recent years, mostly attributable to the continued global war on terror and changes in actuarial liabilities related to its Military Retirement Fund and Health Benefits. HHS and SSA combine to make up nearly half of the 2006 total net cost of operations. The bulk of these agencies' costs are attributable to their administration of the Government's major social insurance programs, e.g., Old Age, Survivors', and Disability Income (Social Security), and Medicare. The Statement of Social Insurance and the supplemental information in this report, as well as the social insurance discussion in this section discuss the current costs and future sustainability of these programs in greater detail.

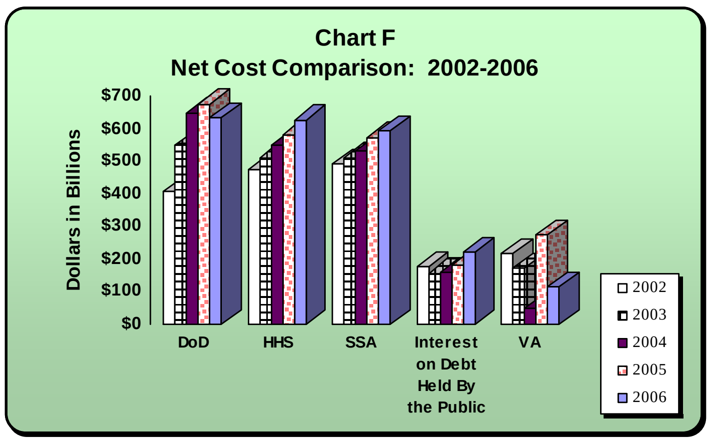


Chart F
Net Cost Comparison: 2002-2006

Among cabinet agencies, the Department of Energy (Energy) experienced the greatest percentage increase in its net cost (+ 52.7 percent), while VA experienced the greatest cost decrease (- 58.3 percent). Both changes resulted from each agency's need to estimate future costs and liabilities based on complex assumptions and cost models. As reported in Energy's 2006 Performance and Accountability Report, Energy's cost increase, in large part, stems from revised estimates of currently unfunded environmental clean-up liabilities. By comparison, VA considers several variables (e.g., number of eligible recipients, discount rates, and life expectancy) in estimating its actuarial liability for future veterans' compensation benefits, which experienced a slight increase of $31.2 billion (2.8 percent) from $1,122.6 billion in fiscal year 2005 to $1,153.8 billion in 2006. A liability balance increase during the year represents the actuarial cost amount for that year. Because a small change in interest rate assumptions produces the large actuarial cost fluctuations shown in Table 8, reported annual VA actuarial costs are not useful in predicting future annual costs. VA's 2006 decrease of nearly $170 billion followed a more than $200 billion actuarial cost increase in 2005 and a nearly $140 billion decrease in 2004. These fluctuations are caused primarily by changes in interest rate assumptions. The change in

Table 8: Change in VA's Total Actuarial Cost: 1999 - 2006

billions of dollars	Estimated Liability (as of Sept. 30)	Liability Change = Actuarial Cost	Change in Actuarial Cost
1999	$483	($95)	–
2000	$553	$69	$164
2001	$692	$139	$70
2002	$849	$157	$18
2003	$955	$106	($52)
2004	$925	($30)	($136)
2005	$1,123	$198	$228
2006	$1,154	$31	($167)

Note: Source: Treasury analysis of VA's 2000-2006 net cost statements. Totals may not add due to rounding.

VA's actuarial costs from year to year accounts for the majority of the change in the Government's net cost in most years (54 percent in 2006). Moreover, in 2006, the change in these and other actuarial (e.g., pension) costs accounted for $242.5 billion of the $310 billion decrease (nearly 80 percent) in total net operating cost. Finally, total actuarial costs in 2006 of $187.2 billion, as in most recent years, account for most of the annual differences (93 percent in 2006) between the Government's budget deficit and net cost, and ostensibly, between the cash and accrual bases of Government accounting.

2006 marks the first fiscal year in which the Government's Statement of Social Insurance (SOSI), which provides perspective on the Government's long term estimated responsibilities and costs, has been prepared and audited as a principal financial statement. It should be noted, however, that even with the addition of the SOSI, the financial statements do not reflect future costs implied by current policy, such as national defense, the global war on terrorism, and hurricane cleanup efforts.

Hurricane Katrina – One Year Later

September 2006 marked the one year anniversary of Hurricane Katrina's assault on the Gulf Coast. Katrina was the most destructive natural disaster in U.S. history. The Federal Government has responded by providing more than $110 billion in resources, plus an additional $8 billion in tax relief – to support the region's reconstruction and renewal. Recovery has proved to truly be a multi-faceted effort, requiring contributions from several Federal agencies, including:

- The Federal Emergency Management Administration has funded more than $5 billion to repair and replace damaged public infrastructure, such as roads and bridges, schools, water systems, public buildings, and public utilities;
- The U.S. Department of Housing and Urban Development (HUD), through its Community Development Block Grants program, as awarded nearly $17 billion in State grants to help rebuild damaged housing and other infrastructure.
- The Department of Education has released nearly $2 billion to help reopen schools and educate students.
- The U.S. Small Business Administration (SBA) has approved more than $10 billion in disaster recovery loans to homeowners, renters, and businesses. More than 22,000 loans totaling more than $2 billion have gone to small business owners.

Source: White House fact sheet, released August 24, 2006. http://www.whitehouse.gov/news/releases/2006/08/print/20060824.html.

Assets and Liabilities: What We Own and What We Owe.

Net Position at the end of the year can also be derived by netting the Government's assets against its liabilities, as presented in the ***Balance Sheet***. It is important to note that the balance sheet does not include the financial impact of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. However, as was the case with the ***Statement of Operations and Changes in Net Position***, 2006 marks the first fiscal year in which the balance sheet separately does include a presentation of the portion of net position attributable to earmarked fund activities. Moreover, the Government's responsibilities are broader than the liabilities presented on the balance sheet, including such 'off-balance sheet items as the Government's future social insurance responsibilities (e.g., Social Security and Medicare), as well as other programs and contingencies. These responsibilities are discussed in this section's Social Insurance and Other Responsibilities discussion, later in this section, and in the supplemental disclosures of this *Report*.

Assets – "What We Own."

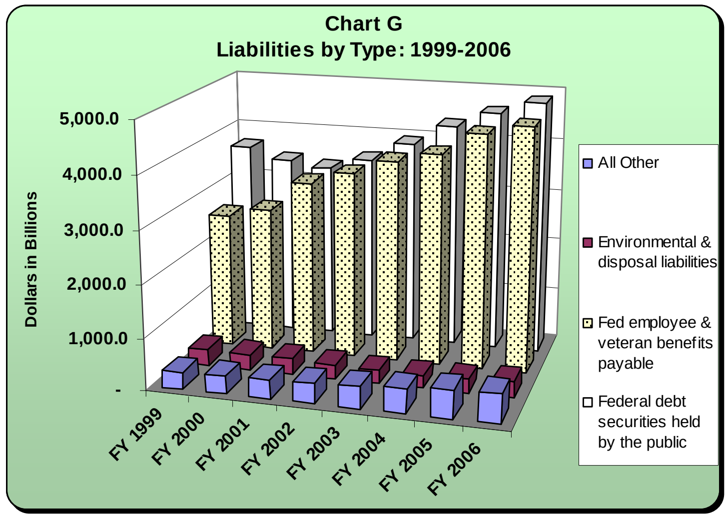
The Government's total assets increased $48.6 billion from $1,447.9 billion in fiscal year 2005 to $1,496.5 billion in 2006. During the year, all government asset balances increased except loans receivable and 'other' assets, which declined slightly. Representing almost 50 percent of total assets this fiscal year, net property, plant, and equipment has been the Government's largest asset over the past seven fiscal years. In fact, the reported value of these assets increased substantially in 2003 as a result of a change in Federal accounting standards. This change resulted in the recognition of a net book value of $325.1 billion in military equipment being presented on the balance sheet for the first time.

Liabilities – "What We Owe."

Chart G shows the major components of liabilities, or what the Government owes, as of September 30, for fiscal years 2002 through 2006. During 2006, total liabilities increased $498.1 billion from $9,914.8 billion in 2005 to $10,412.9 billion.

The largest liability in recent years has been Federal debt held by the public and accrued interest, the balance of which increased to $4,867.5 billion in 2006. The Government borrowed a smaller amount of cash from the public this year primarily because of the sharp increase in tax revenues. Over the past seven fiscal years, Federal debt securities held by the public and accrued interest have moved in tandem with the budget results. ***The Statements of Changes in Cash Balance from Unified Budget and Other Activities*** reports how the annual unified budget surplus or deficit relates to the Federal Government's borrowing and changes in operating cash, and explains how a budget surplus or deficit normally affects changes in debt balances.

The Government's net borrowings from the public increased by $237.2 billion in fiscal year 2006 and by a combined $529.5 billion since 2005 to help finance more than 90% of the budget deficits in those years. Typically, budget surpluses, have resulted in borrowing reductions and budget deficits, have yielded borrowing increases. However, the Government's debt operations are much more complex than this would imply. Each year, trillions of dollars of debt matures and new debt takes its place. For example, in 2006, new borrowings were $4.5 trillion and maturing debts were $4.2 trillion.



Federal employee and veteran benefits payable have been increasing dramatically, from $2,600.7 billion as of the end of fiscal year 1999, to $4,679.0 billion as of fiscal year-end, 2006, making up nearly half of the Government's total reported liabilities in both 2005 and 2006.

The Office of Personnel Management (OPM) administers the largest civilian pension plan, covering about 90 percent of all Federal civilian employees, including 2.6 million current employees and 2.5 million annuitants. By comparison, the military pension plan covers 2.9 million current employees and 1.9 million annuitants. At the end of fiscal year 2006, civilian Federal employee benefits payable of $1,694.3 billion accounted for 36 percent of total Federal employee and veteran benefits payable, and included $1,349.0 billion of pensions, $295.2 billion of health, and $50.1 billion of other benefits.

Environmental and disposal liabilities increased $45.4 billion from $259.8 billion in 2005 to $305.2 billion in 2006. This increase, mainly due to the increases in environmental management baseline estimates at Energy, accounted for 9.1% of the change in total liabilities during 2006.

Social Insurance and Other Responsibilities

Information reported on social insurance programs addresses fundamental questions about their current and future financial condition, including whether scheduled benefits are sustainable with current scheduled income. This information is intended to facilitate an assessment of the programs' long-term sustainability as well as their ability to raise resources from future program participants to pay for benefits to present participants.

For the programs listed as social insurance (e.g., Social Security, Medicare Parts A, B, and D),the Statement of Social Insurance (SOSI) presents the actuarial present value for the projection period of: all future contributions and tax income (excluding interest) received from or on behalf of current and future participants; the estimated future scheduled expenditures paid to or on behalf of current and future participants; and the estimated future excess of contributions and tax income (excluding interest) over future scheduled expenditures. Amounts reported in the SOSI and in the supplemental information in this report are based on the official actuarial trust fund reports for each program.

Social Insurance Trust Funds

The social insurance trust funds were created to account for all related program income and expenses. Social Security and Medicare taxes, premiums, and other income are credited to the funds. Benefit payments and program administrative costs are the only purposes for which disbursements from the funds can be made. Program revenues not needed in the current year to pay benefits and administrative costs are invested in special non-marketable U.S. Government securities on which a market rate of interest is credited. The trust funds represent the accumulated value, including interest, of all prior program annual surpluses and provide automatic funding authority to pay benefits.

Social Insurance Trust Funds

Social Security:
- Old-Age and Survivors Insurance (OASI) pays retirement and survivors benefits,
- Disability Insurance (DI) pays disability benefits.

Medicare:
- Part A: Hospital Insurance (HI), which pays for inpatient hospital and related care.
- Part B: Supplementary Medical Insurance (SMI), which pays for physician and outpatient services
- Part D, SMI prescription drug benefit program.

Trustees Short-Range Outlook (2005-2015)

The adequacy of the OASI, DI, and HI Trust Funds is measured by comparing their assets at the beginning of a year to projected costs for that year (the "trust fund ratio"). A ratio of 100 percent or more (i.e., assets at least equal to projected benefit payments for a year) is considered a good indicator of a fund's short-term adequacy and means that even if expenditures exceed income, the trust fund reserves combined with annual tax revenues would be sufficient to pay full benefits for several years, allowing time for legislative action to restore financial adequacy.

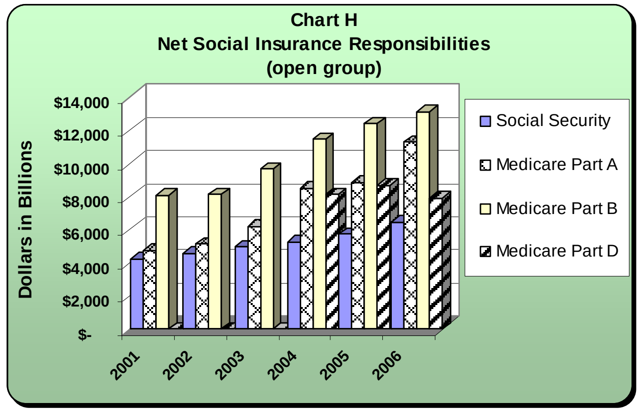
By this measure, the OASI and DI funds are considered financially adequate throughout the short range because the assets of each fund are projected to exceed the 100 percent level through the year 2015. The HI fund does not meet the short-range test of financial adequacy because its assets fall below the 100 percent level of one year's expenditures during 2014. For SMI, a less stringent annual "contingency reserve" asset test applies to both Part B and Part D because the financing of each of those accounts is provided by beneficiary premiums and Federal general fund revenue payments automatically adjusted each year to meet expected costs. Thus, under current law both SMI accounts are fully financed throughout the 75-year projection period no matter what the costs may be.

Trustees Long-Range Outlook (2005-2080)

Social Security and Medicare costs increase steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. Thereafter, Social Security costs grow slowly primarily due to projected increasing life expectancy. Medicare costs continue to grow rapidly due to expected increases in the use and cost of health care. The continued development of new technology is expected to cause per capita health care expenditures to continue to grow faster in the long term, than the economy as a whole.

Comparison of projected Social Security and Medicare costs to gross domestic product (GDP) is a commonly-used metric for fund analysis. Medicare costs are projected to exceed Social Security's in 2024. Social Security expenditures amounted to 4.3 percent of GDP in 2006 and is projected to increase to 6.3 percent of GDP in 2080. Medicare's cost amounted to 3.2 percent of GDP in 2006 and is projected to grow more than threefold to 11.0 percent of GDP in 2080. Absent reform, Social Security and Medicare together will more than double as a percentage of the U.S. economy, from nearly 6 percent in 2006 to over 17 percent by 2080.

The Government’s Net Liabilities and its Responsibilities



Information reported on social insurance programs addresses fundamental questions about their current and future financial sustainability, i.e., the extent to which the Government could meet future demands for resources under current laws and conditions. For the programs listed as social insurance (e.g., Old Age, Survivors’ and Disability Insurance (OASDI) or Social Security, Medicare (Parts A, B, and D)), the Statement of Social Insurance (SOSI) shows the estimated future excess of scheduled benefit expenses over contributions and tax income (excluding interest), based on each program’s actuarial trust fund report.

The social insurance figures in Tables 9 and 10 present estimated net social insurance and other responsibilities for the ‘closed-group’ population. which equals the present value of net payments (benefits less taxes) expected during the projection period (75 years) on behalf of program participants over age 15 at the start of the projection period. While a true accrual measure would count only benefits already earned (and taxes already paid) by current workers, the closed-group liability includes future benefit accruals and future taxes of current workers. In this sense, the closed-group numbers are more forward-looking than a strict accrual-based calculation. They represent an estimate of the responsibility, under current law, of future taxpayers to pay benefits to current participants. For comparative purposes, Table 9 also presents actuarial social insurance estimates for the ‘open group’ population, which differs from the ‘closed group’ by including all future projected participants who will make contributions to postemployment benefit plans and/or receive and/or be eligible to receive benefits over the 75-year horizon. Open group trends are also shown in Chart H. The SOSI details the actuarial estimates attributable to each group.

Table 9: Social Insurance Responsibilities

billions of dollars (details may not add to totals due to rounding).	2002	2003	2004	2005	2006
This table shows the present value of 75-year actuarial projections of the benefit payments under current law for Social Security, Meidcare, and other social insurance programs in excess of their scheduled contributions and earmarked taxes for current participants ages 15 and over at the start of the period.					
Social Insurance Responsibilities, Net (closed group) [1]					
Social Security (OASDI)	**$ (11,216)**	**$ (11,742)**	**$ (12,552)**	**$ (13,583)**	**$ (14,976)**
Medicare:					
Medicare Part A	$ (6,409)	$ (7,287)	$ (9,254)	$ (9,621)	$ (12,153)
Medicare Part B	$ (6,487)	$ (7,720)	$ (9,055)	$ (9,900)	$ (10,630)
Medicare Part D	$ -	$ -	$ (6,306)	$ (6,818)	$ (6,257)
Subtotal: Medicare (Parts A, B, D)	**$ (12,896)**	**$ (15,007)**	**$ (24,615)**	**$ (26,339)**	**$ (29,040)**
Other Social Insurance Programs [2]	$ (107)	$ (109)	$ (112)	$ (116)	$ (131)
Total Social Insurance Responsibilities, Net (closed group)	**$ (24,219)**	**$ (26,858)**	**$ (37,279)**	**$ (40,038)**	**$ (44,147)**
Total Social Insurance Responsibilities, Net (open group) [2]	**$ (17,887)**	**$ (20,825)**	**$ (33,363)**	**$ (35,689)**	**$ (38,851)**

[1] The 'closed group' includes current participants (i.e., receiving and/or are eligible to receive benefits) ages 15 and over at the start of the period. The 'open' group' (shown below for comparative purposes), includes all current and future projected participants (i.e., individuals receiving and/or are eligible to receive benefits ages 15 and over at the start of the period, PLUS participants estimated to receive and/or be eligible to receive beneifts in the future over the 75-year horizon).

2 'Other Social Insurance Programs' for the 'closed' group includes the Railroad Retirement Program. The 'open' group includes both the Railroad Retirement and Black Lung Programs. The SOSI presents only 'open group' totals for Black Lung (i.e., does not identify 'closed' group amounts separately). Therefore, Black Lung is only reflected in the 'open' group amounts above.

Table 9 summarizes the Government’s significant ‘Other Responsibilities’ for fiscal years 2002-2006. Social insurance and other responsibilities include amounts disclosed in the SOSI, as well as amounts disclosed in Notes 19 (Contingencies) and 20 (Commitments) that are not presented on the balance sheet.

Viewing this ‘sustainability’ information in concert with other financial statements and information provides both a short- and long-term view of significant financial issues facing the Government. It should be noted, however, that there are significant differences between liabilities presented on the balance sheet and the responsibilities from the SOSI, which limit their comparability. For the purposes of financial reporting, the ***Balance Sheet*** presents a ‘snapshot’ at a point in time of an entity’s *current* financial condition, with an emphasis on how current and prior actions and events have impacted its assets and liabilities. By contrast, the ***SOSI*** presents the calculated net present value of future estimated revenues and expenditures over an extended period. They represent an assessment of the extent to which the social insurance programs are unfunded under current financing arrangements relative to scheduled benefit obligations. Since they are not liabilities, and therefore do not impact either an entity’s current assets or liabilities, they are considered ‘off-balance sheet’ items; according to Federal accounting standards. While comparability of liabilities to ‘other responsibilities’ is limited, their significance can be analyzed in other contexts.

Table 10: Comparing Net Liabilities to Social Insurance Responsibilities

billions of dollars	2002	2003	2004	2005	2006
Total Assets	$ 997	$ 1,405	$ 1,397	$ 1,448	$ 1,497
Total Liabilities	$ (7,817)	$ (8,500)	$ (9,107)	$ (9,915)	$ (10,413)
Liabilites, net of Assets (balance sheet)	**$ (6,820)**	**$ (7,094)**	**$ (7,710)**	**$ (8,467)**	**$ (8,916)**
Social Insurance Responsibilities, Net (closed group - off-balance sheet)	**$ (24,219.0)**	**$ (26,858.0)**	**$ (37,279.0)**	**$ (40,038.0)**	**$ (44,147.0)**
Net Liabilities and Net Social Insurance Responsibilities - Closed Group (Combined)	**$ (31,039)**	**$ (33,952)**	**$ (44,989)**	**$ (48,505)**	**$ (53,062)**

Table 10 shows how the Government's current net liabilities compare to its estimated future social insurance responsibilities. Fiscal year 2006 total assets of $1,496.5 billion and total liabilities of $10,412.9 billion combine to derive the Government's current net liability of $8,916.4 billion. By comparison, the net present value of estimated future net social insurance responsibilities is $44,147 billion[1]. The net social insurance responsibilities (scheduled benefits in excess of estimated revenues) indicate that those programs are on an unsustainable fiscal path and difficult choices will be necessary in order to address their large and growing long-term fiscal imbalance. Delay is costly and choices will be more difficult as the retirement of the 'baby boom' gets closer to becoming a reality with the first wave of boomers eligible for retirement under Social Security in 2008.

The President's Management Agenda: Managing for Results

Fiscal responsibility requires the sound stewardship of taxpayer dollars. Once the Congress and the President decide on overall spending levels, taxpayer dollars should be managed to maximize results. The President's Management Agenda (PMA) is creating a results-oriented Government where each agency and program is managed professionally and efficiently and achieves the results expected by the Congress and the American people.

Launched in August 2001, the PMA articulates the goal of making the Government more results-oriented, focusing on achievement, efficiency, and accountability. It emphasizes improving Government operations by setting clear goals and implementing action plans, Agencies continue to manage for and achieve better results.

The PMA Executive Scorecard is used to measure agencies' progress and overall achievement in meeting the overall improvement goals, otherwise known as standards for success. The following pages contain an overview and discussion of agency performance on the PMA initiatives:

- Implementing Strategic Human Capital
- Gaining Efficiencies Through Strategic Sourcing
- Improving Financial Performance
- Expanding Electronic Government
- Eliminating Improper Payments
- Budget and Performance Integration.
- Asset Management

PMA Scores

	Status	Progress
Red	Any of a number of serious flaws.	Initiative in serious jeopardy. Unlikely to realize objectives without significant
Yellow	Satisfies intermediate levels of performance in all criteria.	Slippage in implementation schedule, quality of deliverables, or other issues requiring adjustments by agency in order to achieve initiative on a timely basis.
Green	Meets all of the standards for success.	Implementation proceeding according to plans.

The fourth quarter scorecard on the following page and the accompanying discussion of agency performance under the PMA initiative presents the agencies' status and progress ratings as of September 30, 2006. These ratings preceded the publication of the fiscal year 2006 audited financial statements. The status and progress ratings in the first quarter scorecard, as of December 31, 2006, will reflect auditors' findings from the fiscal year 2006 financial statement audit. For example, several agency audit opinions and internal controls declined during 2006. OMB will review these changes and update the status and progress ratings reflecting the fiscal year-end 2006 results during the fiscal year 2007 first quarter assessment cycle. Additional information on the PMA initiatives may be found at www.whitehouse.gov/results/agenda/standards.pdf.

[1] Tables 9 and 10 both focus on closed-group obligations, equal to the present value of net payments (benefits less taxes) expected during the projection period on behalf of program participants over age 15 at the start of the projection period. While a true accrual measure would count only benefits already earned (and taxes already paid) by current workers, the closed-group liability includes future benefit accruals and future taxes of current workers, making the closed-group numbers more forward-looking than a strict accrual-based calculation.

Executive Branch Management Scorecard

	Current Status as of September 30, 2006.					Progress in Implementing the President's Management Agenda				
	Human Capital	Competi-tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra-tion	Human Capital	Competi-tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra-tion
AGRICULTURE	G	G ↑	R	R ↓	Y	Y	G	G	Y	G
COMMERCE	Y	Y	G	Y	G ↑	G	G	G	G	G
DEFENSE	Y	Y ↑	R	R	Y	G	Y	G	R	G
EDUCATION	Y	G	G	G	G ↑	G	G	G	G	G
ENERGY	G	G ↑	R	Y	G	G	G	G	G	Y
EPA	Y	G	G	G ↑	Y	G	G	G	G	G
HHS	G	G	R	R ↓	Y	G	G	G	Y	G
DHS	Y	Y	R	R	Y	G	R	R	G	G
HUD	Y	Y	R	G	Y	G	Y	G	G	G
INTERIOR	G	G	R	Y ↑	Y	G	R	G	R	G
JUSTICE	G	Y	R	Y ↑	G	G	G	G	G	G
LABOR	G	G	G	G	G	G	G	G	G	G
STATE	G	G ↑	G	G ↑	G	G	G	G	G	Y
DOT	G	G	R	G ↑↑	G	G	Y	G	Y	G
TREASURY	G	G	R	Y	Y	G	Y	G	Y	Y
VA	G	R	R	R	R	G	R	G	Y	Y
AID	Y	R	Y	Y	G	G	G	G	G	Y
CORPS	G	Y	R	R	R	G	Y	G	Y	G
GSA	Y	G	R	Y	G ↑	G	Y	G	G	G
NASA	G	G	R	R ↓	G	G	G	Y	R	G
NSF	G	R	G	G	G	G	R	G	G	G
OMB	Y	R	R	Y	R	G	G	G	G	G
OPM	G	G	Y	R	Y	G	G	G	R	G
SBA	Y	G	R	G ↑↑	G	G	G	G	G	G
SMITHSONIAN	Y	R	G	Y	G ↑	G	Y	G	G	G
SSA	G	G ↑	G	Y ↓	G	G	G	G	R	G

Legend: R = Red Y = Yellow G = Green
↑↓ Arrows indicate change in status since evaluation on June 30, 2006.

Strategic Management of Human Capital

HUMAN CAPITAL	
GREEN STATUS as of 9/30/2006	
USDA	Transportation
Energy	Treasury
HHS	VA
Interior	Corps of Engineers
Justice	NASA
Labor	NSF
State	OPM
SSA	

The Strategic Management of Human Capital Initiative recognizes that the men and women serving in the Federal Government are its most important resource. Through this initiative, the Government seeks to maximize the workforce's ability to accomplish agencies' missions for the American people by supporting agency efforts to institute state-of-the-art human capital management systems, including strategic alignment, leadership and knowledge management, results-oriented performance culture, talent management, and accountability. An ultimate goal of the initiative is to "imbed" the strategic management of human capital into an agency's daily management operations. To accomplish this, agencies must transition to a system of strong self-accountability whereby agency leaders will use Human Capital results in strategic decision making.

Workforce planning must assure alignment of federal human capital resources with agency mission, objectives and goals. Agencies must design agile strategic human capital plans to ensure that their workforce has the competencies needed to meet new challenges and demands, perform new functions, and accomplish the agency's mission.

Federal workforce demographics are changing quickly, requiring agencies to identify effective succession management, and service and mission continuity strategies and systems. Agencies are working to pinpoint competency gaps in mission-critical occupations and develop and implement successful strategies to close them. Agencies have made significant progress in establishing and implementing personnel management practices to better achieve their missions. They are deploying and improving performance management systems that better link individual performance to agency mission and results, thus providing the foundation for establishing new compensation systems that reward performance instead of time on the job. Federal executives play a key role. Over the past year, agencies have improved their SES performance plans, particularly in the way performance measures are established. These programs aim not only to ensure that potential future managers are waiting in the wings, but that those individuals have the proper skills to work in today's changing work environment.

Competitive Sourcing

COMPETITIVE SOURCING	
GREEN STATUS as of 9/30/2006	
USDA	State
Education	Transportation
Energy	Treasury
EPA	GSA
HHS	NASA
Interior	OPM
Labor	SBA
SSA	

Managers of highly commercial activities – including those responsible for finance and accounting activities and information technology support – are using public-private competition to make common-sense determinations about whether our taxpayers are better served through performance by the most efficient government organization or, alternatively by the best qualified contractor. Competitions are helping agencies find new and better ways of delivering service to taxpayers by leveraging technology, lowering contract support costs, realigning their workforces, and establishing clearer performance standards. Competitions completed between fiscal years 2003-2005 are expected to generate more than $5 billion over the next 10 years, which equates to about $23,000 in annualized net savings for every job examined through competition. Savings will continue to grow as more competitions are completed and cost control and performance efficiencies are brought to bear on a larger number of daily tasks. Agencies could generate taxpayer savings of more than $4 billion annually by competing just half of the commercial FTEs identified as suitable for competition in their workforce inventories.

Improved Financial Performance

FINANCIAL PERFORMANCE	
GREEN STATUS as of 9/30/2006	
Comerce	State
Education	NSF
EPA	Smithsonian
Labor	SSA

The ultimate goal of the President's Management Agenda (PMA) Improved Financial Performance initiative is for managers to have access to reliable financial information for decision-making. Reliable and timely financial information is measured in many ways such as the rendering of an unqualified opinion from the independent auditor on the agency's financial statements, the absence of material internal control weaknesses, and reporting annual financial information by November 15 and meeting other relevant reporting deadlines. For fiscal year 2006, the Government strengthened its requirements for reliable and timely financial information by making agencies subject to updated guidance on management's responsibility for internal control. This guidance (OMB Circular A-123, Management's Responsibility for Internal Control) requires management to undertake a more rigorous assessment process over internal controls over financial reporting, including direct testing, and for agency heads to provide a separate management assurance on the internal control over financial reporting.

Federal agencies continue to show their resolve in meeting these requirements as demonstrated by their continuing efforts to implement rigorous corrective actions plans to reduce material process, systems, and control weaknesses. In conjunction with the implementation of new financial management controls and processes and accelerated reporting schedules, these accomplishments lay the foundation for the production and availability of more reliable information to support day-to-day management.

Improved financial business practices, management systems, and reporting tools enable agencies to enhance the timeliness, accuracy, and reliability of financial information. These improvements yield better management of Federal dollars, and consequently, greater taxpayer confidence that the proper safeguards are in place for effective financial stewardship.

Expanded Electronic Government

E-GOVERNMENT	
GREEN STATUS as of 9/30/2006	
Education	**State**
EPA	**Transportation**
HUD	**NSF**
Labor	**SBA**

The Expanded Electronic Government initiative focuses on two key areas—strengthening agencies' management of their information technology (IT) resources and using the Internet to simplify and enhance service delivery to the citizen. The Government must capitalize on its approximate $65 billion annual investment in IT.

Most agencies have improved their IT management since fiscal year 2003. Also, 88 percent of agency IT systems have been certified and accredited, up from 85 percent the previous year. In addition, currently about 83 percent of agencies have an effective enterprise architecture, an integral part of ensuring their IT investments support overall agency goals and do not duplicate Government-wide IT investments. Such improvements are central ingredients in developing a more focused and results-oriented approach to IT investment across agencies.

Specific improvements in service delivery are being achieved through the E-Gov Initiatives. For instance, GovBenefits.gov has expanded assistance information available through the site, now including links to some state-funded, state-administered programs. The addition of state links ensures GovBenefits.gov is truly a one-stop resource for government benefits. To date, GovBenefits.gov has provided benefits information to more than 22 million visitors and referred nearly 5 million citizens to benefit programs. Another E-Gov Initiative, Grants.gov, hosts information regarding all of the Federal grant programs on its site. In fiscal year 2006, 76 percent of all Federal discretionary grant opportunities (2,092 out of 2,757) were available for electronic application via Grants.gov and grantees submitted more than 86,000 applications through Grants.gov. This is a 32 percent increase over the number of opportunities that were available for electronic application submission in 2005 (44 percent) and Grants.gov has received more than 5 times the number of applications submitted in 2005 (16,000).

Through the E-Payroll initiative, the Federal Government has consolidated many payroll systems, reducing the cost of payroll processing. For example, the Department of Health and Human Services (HHS) has reduced its annual costs of payroll processing for its more than 65,000 employees by almost $11 million, from $259 to $90 per employee. The Environmental Protection Agency (EPA) has also reduced its average cost from $270 to $90 per employee; with its staff of 18,000 the agency has realized an annual savings of approximately $3.2 million.

Grants Management Line of Business (GMLOB) is working to create a common solution for grants management that will promote citizen access, customer service, and agency financial and technical stewardship. To date, three agencies (ED, HHS-ACF, and NSF) have been designated as Federal consortia leads. These agencies offer shared grants management technical solutions and services that will allow partner agencies to process grants in a decentralized way using common business processes. Consortium leads will spread operations and maintenance (O&M) costs, and development, modernization, and enhancement (DME) costs across agencies, decreasing the burden that any one agency must bear. Automated business processes available through consortium lead agencies will decrease agency reliance on manual and paper-based processing.

The Government is investing significant resources in IT to assist it in achieving its mission and better serving the American taxpayer. Agencies are making improvements towards ensuring these investments are well managed, more secure, and providing services to the American people more efficiently and effectively.

Budget and Performance Integration

BUDGET & PERFORMANCE INTEGRATION	
GREEN STATUS as of 9/30/2006	
Commerce	Transportation
Education	USAID
Energy	GSA
Interior	NASA
Justice	NSF
Labor	SBA
State	Smithsonian
SSA	

Executive departments and agencies are using meaningful program performance information to inform their budget and management decisions. They are asking whether their programs are working and, if not, they are taking steps to improve them. Assessments of programs using the Program Assessment Rating Tool (PART) have helped focus agency efforts to improve program results. OMB and agencies have now assessed the performance of more than 800 Federal programs, representing almost $1.5 trillion dollars in Federal spending. Summaries of PART findings for each program assessed, as well as the detailed PART analyses for those programs, can be found at the OMB website. The Administration will also launch a new website, ExpectMore.gov, to provide greater public access to information about what programs work, which ones don't, and efforts to improve.

The Administration is also using the PART to compare the performance and management of similar programs across Government so that lessons about how to improve program performance can be shared among those programs. These analyses will tell us what steps we need to take to improve program performance for similar programs across Government.

The PART is a vehicle for improving program performance. As more and more program assessments are conducted, the Administration will have better program performance information to use when making budget and management decision. Agencies will be better able to describe to the taxpayer what they are getting for their investment and what improvements in efficiency and results can be documented every year.

Eliminating Improper Payments

An improper payment occurs when the funds go to the wrong recipient, the recipient receives the incorrect amount of funds, the recipient uses the funds in an improper manner, or when a duplicate payment occurs.[2] In fiscal year 2006, the Government continued to make progress toward identifying all Government-wide improper payments and is well on its way to establishing a baseline measurement for all programs susceptible to improper payments. Currently, 85 percent of all high-risk programs are reporting an improper payment error measurement ($1.3 trillion of $1.5 trillion in high-risk programs) and the number of high-risk programs reporting is increasing annually. A key achievement in 2006 was establishing error measurement plans for a majority of the remaining high-risk programs.

OMB anticipates that 57 or more programs will likely report on their program integrity efforts through their fiscal year 2006 Performance and Accountability Reports (PAR) under the Improper Payments Information Act (IPIA) of 2002 (compared with 30 reporting programs in 2004, the initial year of implementation). Programs reporting for the first time in 2006 include the Special Supplemental Nutrition Program for Women, Infants, and Children, the Child and Adult Care Food Program, and the Individual and Household (temporary housing due to natural disasters) Program. Beginning in 2007, Medicaid, Temporary Assistance to Needy Families, and the State Children's Health Insurance Program will report component error rates. In 2008, OMB projects that these programs will be reporting comprehensive national error measurements. At that point, the OMB projects that virtually all of high-risk programs will be reporting a national improper payment estimate.

Much of this success can be attributed to agency commitment to identify and reduce improper payments, the Chief Financial Officers (CFO) Council's Improper Payments Transformation Team, and the PMA initiative. Another key success factor has been information sharing. To that end, the CFO Council's Improper Payments Transformation Team will co-sponsor an event in fiscal year 2007 to facilitate State-to-State and program-to-program best practices discussions on program integrity for means-tested programs.

OMB continues its commitment to identify all improper payments Government-wide and to help agencies establish corrective action plans to address their root causes. In some cases, this might lead to legislative and/or regulatory changes. Regardless, taxpayers will be more fully served by the assurance that their tax dollars are being used in proper amounts and for their intended purposes.

Asset Management

Pursuant to the PMA Real Property Management program initiative, agencies continue to make significant progress in implementing the tools necessary to manage the size, condition, and costs of their asset portfolios and comply with the requirements of Executive Order 13327, Federal Real Property Asset Management. In fiscal year

[2] From OMB website - - http://www.whitehouse.gov/omb/financial/fia_improper.html

2006, Executive agencies reported more than 1.2 million assets, including land, buildings, and structures, to the Government-wide real property inventory, which provides, for the first time, a more complete picture of the Government's asset inventory; where the assets are located; and how and whether the assets are being used effectively to help serve agency mission and objectives. The Federal Real Property Council has also established a Performance Assessment Tool that helps agencies evaluate the performance of their real property portfolio and identifies assets for potential improvement or disposition. Having the inventory and performance information means that agencies, and the Government as a whole, can make smarter asset management decisions.

The Administration continues to hold agencies accountable for their asset management goals through the PMA process. Since fiscal year 2004, agencies have shown significant improvement in their asset management processes and their ability to gather and use inventory and performance data to drive the decision-making process toward the rightsizing the Government's real property assets. Executive Agencies have disposed of more than $3.5 billion in real property assets and are well on the way to meeting the Administration's goal of disposing $9 billion in assets by the close of fiscal year 2009.

Systems, Controls, & Legal Compliance

Systems

As Federal agencies have continued to demonstrate success in obtaining and keeping unqualified opinions on their audited financial statements, the Federal Government continues to face challenges in implementing financial systems that meet Federal requirements. In January 2006, the latest version of the Core Financial Systems requirements were released, and most major agencies are in the process of having completed or implementing certified commercial-off-the-shelf financial management systems that meet these requirements. However, many agencies continue to struggle when implementing these complex systems and agency auditors' Federal Financial Management Improvement Act (FFMIA) reviews have indicated that a majority of CFO Act agencies experience challenges with their financial management systems.

The Financial Management Line of Business (FMLoB) initiative is intended to help agencies implement financial systems compliant with Federal requirements. It is intended to improve the cost, quality, and performance in the Government's financial management systems by leveraging shared service solutions and implementing Government-wide reforms that improve efficiency of financial operations. OMB expects this initiative to help agencies meet Federal standards and achieve efficiencies, while delivering cost savings to the taxpayers.

Multiple FMLoB initiatives are underway that will collectively make these improved results possible, including standardizing financial processes across the Government, creating opportunities for agencies to move financial systems to shared-service providers where a single provider supports multiple customers, and increasing transparency by establishing performance measures to evaluate the results of these efforts. Through the FMLoB and other information-sharing initiatives, the Federal financial community is working to ensure that mistakes of the past are not repeated and that agencies initiating complex modernization efforts have a clear understanding of significant risks and appropriate mitigation strategies.

Controls

Federal managers have a fundamental responsibility to develop and maintain effective internal control. Effective internal control helps to ensure that programs are managed with integrity and resources are used efficiently and effectively through three objectives: effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The safeguarding of assets is a subcomponent of each objective.

The Federal Managers' Financial Integrity Act (FMFIA) requires the head of each executive agency to annually prepare a statement reporting the effectiveness of the agency's internal control and whether its systems comply with the federal financial system requirements. OMB Circular No. A-123, *Management's Responsibility for Internal Control* (A-123), provides instruction to agencies in implementing the FMFIA and the OMB Circular No. A-127, *Financial Management Systems*, provides instruction for complying with the federal financial system requirements (see the Systems section for more discussion on federal systems).

Recognizing the importance of effective internal control within Federal agencies, OMB revised A-123 in December 2004. The revisions to A-123 primarily focused on providing agencies with a framework for assessing and managing financial reporting risks more strategically and effectively. Appendix A of the revised A-123 required management to undertake a more rigorous assessment process and for agency heads to provide a separate management assurance on the internal control over financial reporting.

Fiscal year 2006 was the initial year that the 24 CFO Act agencies began to implement the new requirements in the Appendix A of the A-123. Some agencies elected to implement the new requirements over multiple years rather than in this initial year, which was permitted by OMB. Those agencies specified their multi-year implementation strategy in their respective assurance statements. Over this past fiscal year, each agency completed risk assessments, identified key processes and controls, and tested these controls to determine their effectiveness, in accordance with A-123. These efforts culminated in the agencies' first management assurance statement specific to the internal control over financial reporting as of June 30, 2006. The separate assurance on the internal control over financial reporting is included in each agency's Performance and Accountability Report as a subset of the overall FMFIA statement.

During fiscal year 2007, OMB will continue to work with the Chief Financial Officers' Council to identify potential areas for additional guidance and to share best practices and strategies that agencies found most helpful during the initial year of implementation. OMB will also continue to incorporate key milestones from agencies' plans for this year's assessment into the Improved Financial Performance initiative scorecard under the President's Management Agenda to ensure agencies are accountable for meeting their goals.

While many agencies are making progress on identifying and resolving deficiencies found in internal control, continued diligence and commitment is needed. However, effective internal control is not only a challenge at the agency level, but it is also a challenge at the Government-wide level. Consequently, GAO has issued an adverse opinion on the effectiveness of the internal control for the Government as a whole, in its report.

Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management. Compliance is addressed as part of agency financial statement audits. Agency auditors test for compliance with selected laws and regulations related to financial reporting. Certain individual agency audit reports contain instances of noncompliance. None of these instances were material to the Government-wide financial statements. However, GAO reported that its work on compliance with laws and regulations was limited by the material weaknesses and scope limitations discussed in its report.

Additional Information

The appendices to this *Report* contain the names and web sites of the significant Government entities included in the *Financial Report's* financial statements. Details about the information contained in this report can be found in these entities' Performance and Accountability Reports. Related Government publications, include, but are not limited to:

- the *Budget of the United States Government*,
- the *Treasury Bulletin*, the *Monthly Treasury Statement of Receipts and Outlays of the United States Government*,
- the *Monthly Statement of the Public Debt of the United States*,
- the *Economic Report of the President*, and
- the *Trustees' Reports* for the Social Security and Medicare Programs.