Issue Date	November 8, 2006
Audit Case Number	2007-FO-0002

TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

Randy W. McGinnis

FROM: Randy W. McGinnis, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2006 and 2005

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), the Office of Inspector General engaged the independent certified public accounting firm of Urbach Kahn and Werlin LLP to audit the fiscal years 2006 and 2005 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to generally accepted government auditing standards.

Urbach Kahn and Werlin LLP is responsible for the attached auditors' report dated October 30, 2006 and the conclusions expressed in the report. Accordingly, we do not express an opinion on FHA's financial statements or conclusions on FHA's internal controls or compliance with laws and regulations.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. Under Federal Accounting Standards Advisory Board (FASAB) standards, a general-purpose federal financial report should include as required supplementary information a section devoted to Management's Discussion and Analysis (MD&A) of the financial statements and related information. The MD&A is not included with this report. FHA plans to separately publish an annual report for fiscal year 2006 that conforms to FASAB standards.

The report contains three reportable conditions and one instance of non-compliance with certain provisions of applicable Laws and Regulations. For tracking purposes, Exhibit 1, Schedule of Questioned Costs and Funds Put to Better Use, is also attached to capture the dollar amount recommended for contract closeout and deobligation in recommendation 1b. Five recommendations are new to this year's report. Based on the information provided in management's response to Urbach Kahn and Werlin's audit, we will record management decisions in the department's Audit Resolution and Corrective Action Tracking System for these five new recommendations.

We appreciate the courtesies and cooperation extended to the Urbach Kahn, and Werlin and OIG audit staffs during the conduct of the audit.

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Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT

Inspector General
US Department of Housing and Urban Development

Commissioner
Federal Housing Administration

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA), a wholly owned government corporation within the United States Department of Housing and Urban Development (HUD), as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources (Principal Financial Statements) for the years then ended. The objective of our audits was to express an opinion on these financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on its financial statements.

Introduction

We concluded that FHA's Principal Financial Statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the following matters being identified as reportable conditions:

- FHA should improve its funds control processes.
- FHA must enhance the controls around the User Access Request (UAR) process.
- FHASL needs to be managed as a mission critical system at the HITS data center.

We found one reportable instance of noncompliance with certain provisions of applicable laws, regulations, contracts and grant agreements. FHA and certain of its allotment holders did not have an approved Funds Control Plan as required by HUD policy.

These results and our findings are discussed more fully below.

INDEPENDENT AUDITOR'S REPORT, CONTINUED

Management Responsibilities

Management is responsible for the information in the Annual Management Report, including the: (1) Principal Financial Statements in conformity with accounting principles generally accepted in the United States of America, (2) Management's Discussion and Analysis (including the performance measures), and (3) Required Supplementary Information. Management is also responsible for establishing and maintaining internal controls over financial reporting and complying with laws, regulations, contracts, and grant agreements, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

Auditor Responsibilities

Our responsibility is to express an opinion on FHA's Principal Financial Statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. These standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misstatement.

An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of FHA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

Opinion on the Principal Financial Statements

In our opinion, the Principal Financial Statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2006 and 2005, and its net cost, changes in net position, combined budgetary resources, and reconciliation of budgetary obligations to net cost for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The information in the Management's Discussion and Analysis and Required Supplementary Information sections is not a required part of the Principal Financial Statements, but is supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITOR'S REPORT, CONTINUED

Internal Control Over Financial Reporting

In planning and performing our audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determined whether internal controls had been placed into operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the Principal Financial Statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

However, we noted certain matters, summarized below and more fully described in Appendix A, involving the internal control and its operation that we consider to be reportable conditions:

- ***FHA should improve its funds control processes***.

  HUD's Administrative Control of Funds Policies and Procedures Handbook No. 1830.2 REV-5 requires each allotment holder submit an acceptable Funds Control Plan, review open obligations that are over certain threshold limits, and ensure that disbursements do not exceed obligations. FHA and certain of its allotment holders have been operating without an approved Funds Control Plan for the past three fiscal years, have not reviewed unliquidated obligations annually and in certain instances, authorized expenditures in excess of obligations. Without proper funds control procedures, FHA management cannot ensure that its budgetary resources are effectively managed and obligations and expenditures will not exceed authorized limits of the funds allotted.

INDEPENDENT AUDITOR'S REPORT, CONTINUED

- ***FHA must enhance the controls around the User Access Request (UAR) process.***

  FHA's Office of Housing maintains eleven separate application systems for managing its Single Family Insurance programs and four applications for managing its Multifamily programs. Several of these applications are interfaced with FHA's core financial management system, the FHA Subsidiary Ledger (FHASL). HUD has a centralized process to ensure users are given proper access to needed applications. We found that a significant number of user access request forms that were requested during our audit for one system were either unavailable or were incomplete. Most of the missing forms related to system access requests that were issued prior to FY2005. Without proper tracking of account access approvals, management cannot ensure that access rights are based on the control concept of least privilege that were authorized by the appropriate parties.

- ***FHASL needs to be managed as a mission critical system at the HITS data center.***

  The FHASL application is maintained at the HUD Information Technology Services (HITS) Data Center facility in Charleston, West Virginia. FHASL was not contractually considered a mission critical system by the HITS data center. Accordingly, FHASL was not included in the disaster recovery backup plans for mission critical systems covered by the data center contract. Given that the systems backup tapes are stored offsite, any disruption in service could have had a significant impact on system access and downtime. The data center contract for FY2007 will include FHASL as a mission critical system for disaster recovery planning purposes.

Additional detail and the related recommendations for these findings are provided in Appendix A of this report. The full text of management's response is included in Appendix B. Our assessment of management's response is included in Appendix C. The current status of prior year findings and recommendations is included in Appendix D.

With respect to certain key performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls related to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We also noted other less significant matters involving the internal control and its operation, which we have reported to the management of FHA in a separate letter, dated October 30, 2006.

Compliance with Laws and Regulations

As part of obtaining reasonable assurance about whether FHA's Principal Financial Statements are free of material misstatements, we performed tests of FHA's compliance with certain

INDEPENDENT AUDITOR'S REPORT, CONTINUED

provisions of applicable laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 06-03.

Our audit procedures were not designed to test the requirements of OMB Bulletin No. 06-03 relating to FFMIA which are not applicable to FHA. Compliance with FFMIA will be evaluated and reported on by the HUD Office of Inspector General (OIG) in connection with their audit of the consolidated financial statements of HUD. We limited our tests of compliance to the provisions described above and we did not test compliance with all laws, regulations, contracts and grants applicable to FHA. Providing an opinion on compliance with certain provisions of laws, regulations, contracts and grants was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws, regulations, contracts and grants described above, exclusive of FFMIA, disclosed a potential instance of noncompliance that is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 06-03, as described below.

- **FHA and certain of its allotment holders did not have an approved Funds Control Plan as required by HUD policy.**

  As discussed in the first reportable condition above, FHA and certain of its allotment holders did not have an approved Funds Control Plan for FY2006. The HUD Appropriation Law for FY2003 (Public Law 108-7) requires HUD and its allotment holders maintain an adequate system of accounting for its appropriations and other available funds. HUD requires each allotment holder to evidence this system of budgetary and accounting control through the submission of an Annual Funds Control Plan to HUD's Chief Financial Officer for review and monitoring.

Specific conditions and recommended remedial actions attributable to this noncompliance are more fully described in the first reportable condition above and in Appendix A. The FHA Office of the Comptroller is responsible for the Funds Control Plans relating to FHA budget authority.

Additionally, the HUD Office of the Chief Financial Officer and CFO Appropriation General Counsel are currently investigating potential Anti-Deficiency Act violations associated with the commitment limitation for FHA's General Insurance/Special Risk Fund programs. No final legal determination regarding these potential compliance matters have been made.

INDEPENDENT AUDITOR'S REPORT, CONTINUED

Distribution

This report is intended solely for the information and use of the HUD OIG, the management of HUD and FHA, OMB, the Government Accountability Office and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Urbach Kahn & Werlin LLP

Washington, DC
October 30, 2006

Appendix A
Reportable Conditions and Material Weaknesses

The following internal control matters are considered Reportable Conditions:

1. FHA should improve its funds control processes.

FHA needs to improve controls over its funds control processes in order to effectively monitor and control budgetary resources and to ensure full compliance with HUD's funds control requirements. The HUD Administrative Control of Funds Policies and Procedures Handbook No. 1830.2 REV-5 (HUD Handbook) requires each FHA allotment holder to submit to the Office of the Chief Financial Officer (OCFO) an acceptable Funds Control Plan each year, review open obligations that are over certain threshold limits, and ensure that disbursements do not exceed contract obligations. FHA has been operating without an approved Funds Control Plan for the past three fiscal years, unliquidated obligations were not reviewed annually and in some instances, expenditures exceeded obligations.

FHA's Comptroller noted FHA was conditionally approved by the Chief Financial Officer (CFO) based on a July 2003 memo and, therefore, not required to submit an annual funds control plan pending completion of FHA Subsidiary Ledger (FHASL) Project. We reviewed the July 31, 2003 memo and HUD's policies for funds control, and determined that while the CFO conditionally approved FHA's FY 2003 Fund Control Plan based upon FHA's interim control processes put in place pending completion of the FHA Subsidiary Ledger Project, FHA was still required to submit its Funds Control Plans for subsequent periods. The July 31, 2003 memo stated that the CFO's approval of the FY 2003 Funds Control Plan was conditional upon:

- A continuation of FHA's interim control processes with further documentation of those interim controls in FHA's 2004 plans;
- Continued progress in developing and implementing improved funds control capabilities under the FHASL Project; and
- Establishment of a working group of FHA and OCFO staff to assess best practices for providing funds control over credit subsidy programs, with feedback to the on-going FHASL Project.

The HUD Handbook also requires FHA to annually review obligations over a certain threshold limit to ensure excess obligations are deobligated for budgeting purposes. We noted that although FHA reviewed contract obligations in fiscal year 2006, no reviews were conducted in the previous two fiscal years.

We sampled 95 contracts with undisbursed balances totaling $410,853,985 as of June 30, 2006, and noted that 51 contracts totaling $121,985,561 should have been administratively closed out one to three fiscal years ago based on the lack of recent activity. As of September 30, 2006, FHA deobligated $14,808,965 relating to the contracts we reviewed, leaving a balance of $107,176,596 to be deobligated in fiscal year 2007.

One of the essential functions of funds control is to prevent authorizing or making expenditures exceeding the amount obligated for a particular contract or grant activity. As of June 2006, we reviewed 47 Management and Marketing contracts and noted that management controls were not sufficient to identify and correct for two contracts when the obligations were insufficient to cover the expenditures. Management has since obligated the additional required funds.

Appendix A
Reportable Conditions and Material Weaknesses

Because of a lack of a Funds Control Plan to annually review the validity of open obligations, excess funding was not deobligated timely and thus, FHA was unable to put these funds to better use to support other FHA program activities. FHA should establish interim funds control policies and procedures while the funds control module in the FHASL Project is being enhanced to ensure funds are properly managed and controlled at a transaction level in compliance with HUD's funds control policies.

Recommendations to address the above include:

1a. FHA's Assistant Secretary for Housing should implement interim Headquarters and field control policies and procedures to ensure that effective funds control is maintained until full implementation and integration of the subsidiary application systems is accomplished. (New)

1b. FHA's Assistant Secretary for Housing should effectively coordinate with HUD's Office of the Chief Procurement Officer to ensure expired or inactive contracts are promptly closed out and that any excess funds, including the $107,176,596 identified in the FY2006 audit, are deobligated timely. (New)

2. FHA must enhance the controls around the User Access Request (UAR) process.

To manage its complex mortgage insurance business, FHA requires large amounts of financial and non-financial data from lenders, borrowers and trading partners such as multifamily project owners, vendors, agents, etc. FHA's Office of Housing maintains eleven separate application systems for managing its Single Family Insurance programs and four Multifamily insurance application systems. Several of these applications are interfaced with FHA's core financial management system, the FHA Subsidiary Ledger (FHASL). These applications are maintained at the HUD Information Technology Services (HITS) Data Center facility in Charleston, West Virginia.

HUD has a centralized process to ensure users are given proper access to needed application systems. All users must complete a standard user access request form which is signed by the immediate supervisor or contract Government Technical Representative before forwarding it to ADP Security for account initiation. According to the HUD Information Technology Security Policy, Program Office/System Owners shall ensure that user access is reviewed once a year. These access lists should then be validated with ADP Security.

We requested 27 UAR forms for a sample listing of system administrators and users for the SAMS application (A80S) at the HITS Data Center facility to determine if a management approved access request form was on file. HUD was able to locate 13 of the 27 contractor request forms and none of the four request forms for HUD employees. Most of the missing system access requests forms were approved prior to the change to the current HITS contractor. Without proper tracking of account access approvals, management cannot ensure that access rights are based on the control concept of least privilege for users that were authorized by the appropriate parties. Additionally, there is an increased risk that unauthorized individuals could access and use the system without a demonstrable chain of management approval to do so.

Appendix A
Reportable Conditions and Material Weaknesses

Recommendations to address the above include:

2a. The HUD Chief Information Officer should ensure that the Deputy Chief Information Officer for Security maintain current and complete records of User Access Request (UAR) forms for all FHA application systems. (New)

2b. The FHA Comptroller should ensure that each FHA application owner reviews and updates their user access list annually and reconciles their records with the ADP Security Office. The UAR forms should be electronically stored by the HITS contractor in a non-editable format in the Lotus Notes environment. (New)

3. FHASL is not managed as a mission critical system at the HITS data center.

FHASL is not considered a mission critical system by the HITS data center due to the fact that it was not in the critical system list when the contract was awarded. Accordingly, it is not included in the disaster recovery backup plans for mission critical systems covered by the data center contract. Due to HITS contractual issues, the FHASL application and data were not being replicated and might not be able to be recovered in a timely manner in the event of a data center or data communications disruption. The data center contract for FY2007 will include FHASL as a mission critical system for disaster recovery planning purposes.

Our recommendation to address the above follows:

3a. The HUD Chief Information Officer should ensure that the disaster recovery backup plans maintained by the HITS contractor are updated to include FHASL. The backup plans should also be tested to ensure data can be restored within the contractually required timeframe. (New)

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Appendix B
Management's Response to Recommendations

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

October 25, 2006

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

//signed//
FROM: Ronald Y. Spraker, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Response to UKW's Fiscal Year 2006 FHA Audit Report

I am pleased to present Federal Housing Administration (FHA) management's responses to your audit report on the fiscal year 2006 FHA financial statements.

General Comments

FHA is pleased that UKW has noted progress in many areas, especially in regards to the improvements made to FHA's risk assessment and Loan Guarantee Liability estimation processes. FHA is pleased to note that we have no material weaknesses. The third reportable condition relating to the FHASL's mission critical status has been resolved subsequent to the identification of this finding, therefore we believe this finding should be eliminated. Additionally, FHA has taken considerable steps to address prior systems findings and will continue to make additional improvements.

Report on Internal Controls – Reportable Conditions

1. FHA should improve its funds control processes.

FHA does have funds control procedures to ensure obligations and expenditures do not exceed authorized limits. The FHA Subsidiary Ledger is being implemented with funds controls being a main priority and focus. The Subsidiary Ledger is currently working as designed with appropriate funds controls in place. We have implemented daily funds control at the allotment level. FHA's funds control processes were documented during FY 2006 with flowcharts that identify all points of fund control. As FHA's implementation progresses, efforts are continuing to update FHA's previous plans.

FHA completed a review of unliquidated obligations in FY 2006. Through this review, FHA identified numerous contracts potentially eligible for contract closeout. In response to our review,

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certain contract balances were closed out and deobligated through the required process. FHA has taken steps to improve the timely review of unliquidated contract balances. Additionally, FHA participates in the CFO's annual review of unliquidated balances. This review includes all administrative contracts and grants in HUDCAPS and PAS/LOCCS.

As part of the unliquidated obligations review, FHA identified two contracts awarded in 1999 where the expenditures may have exceeded the obligations. These were presented to the program area for analysis. Upon further research, it was determined that the expenditures did not exceed the obligations.

In response to recommendation number 1.a, FHA does have funds control policies and procedures to ensure funds are properly managed and controlled. As the primary funds control mechanism, FHA uses Commitment Control within the FHA Subsidy Ledger to ensure that transactions are "budget checked" daily. During FY 2007, FHA will update its funds control plans to incorporate these policies and procedures.

In response to recommendation 1.b., FHA will work with the Office of the Chief Procurement Officer to identify contracts eligible for closeout. Annually, FHA will conduct a review of unliquidated obligations in accordance with FHA's "Procedures for Annual Review of Unliquidated Obligations not covered under the Office of the CFO's Annual Review."

2. FHA must enhance the controls around the User Access Request (UAR) process.

Each Housing data system installed on HUD's infrastructure has a Security Administrator (SA). This person is a Housing employee within the office that owns and sponsors the system. Each User Access Request (UAR) form is submitted via e-mail to the SA who reviews the request. As an employee working in the specific program area supported by the system, the SA is in a position to confirm the individual has a business need for access to the system and to evaluate the range of permissions requested. The SA may reject the request or modify the permissions requested. Upon approval and concurrence, the SA forwards the e-mail along with his or her concurrence to ADP security. ADP security controls the creation and modification of the user ID/password and profiles for each system.

In addition, the Department is working to implement an improved system for User Access Requests. The basic process begins with a web form that is transferred to ServiceDesk and then tracked to closure. Using the ServiceDesk platform will not only improve tracking, retention, and retrieval of the UARs, it will also "lock down" the UAR as Service Desk tickets can not be altered.

The requirement for system owners to review and update their UAR forms on an annual basis and communicate any change to the HITS contractor is documented in the HUD IT Security Handbook.

Regarding recommendation 2.a., Effective immediately, HUD CIO will ensure that ADP security maintain records of User Access Request forms for all FHA application systems.

Regarding recommendation 2.b., The FHA Comptroller will ensure that each FHA application

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Management's Response to Recommendations

owner reviews and updates the user access list annually and reconciles the records with ADP Security.

3. FHASL needs to be managed as a mission critical system at the HITS data center.

Subsequent to when this finding was submitted, the condition changed. On September 30, 2006 HUD accepted a technical and cost proposal to modify the HUD Information Technology Services contract to provide, among other things, backup support at the SunGard facility as part of the disaster recovery backup plan for critical systems. As a consequence, we believe this finding was eliminated in FY2006.

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Management's Response to Recommendations

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

November 6, 2006

MEMORANDUM FOR: Urbach Kahn & Werlin LLP

Ronald Y. Spraker

FROM: Ronald Y. Spraker, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Subsequent Response to UKW's Fiscal Year 2006 FHA Audit Report

This memo is submitted in response to FHA's Fiscal Year 2006 Compliance with Laws and Regulations received subsequent to FHA's original response dated October 25, 2006.

Compliance with Laws and Regulations

The "Compliance with Laws and Regulations" section of the draft report states that FHA is not in compliance with laws and regulations because it did not follow the requirements for a system of funds control as outlined in HUD's FY 2003 Appropriations Act (Public Law 108-7). FHA has provided for an adequate system of funds control for its appropriated and other budgetary resources. While the reportable condition separately identified opportunities to improve and strengthen the contract close-out process and funds control documentation, the nature of the issues identified do not warrant reporting the current processes as non-compliant with laws or regulations. FHA, therefore, disagrees and requests reconsideration and deletion of this non-compliance. The referenced statute states:

Provided further, that no official or employee of the Department shall be designated as an allotment holder unless the Office of the Chief Financial Officer (OCFO) has determined that such allotment holder has implemented an adequate system of funds control and has received training in funds control procedures and directives.

The statute gives the authority to the CFO to determine whether or not an allotment holder has adequate systems of funds control. The CFO reviewed FHA's funds control systems and determined that they were adequate, that until FHA moved further along with systems implementation the requirement for annual funds control plans would be waived and FHA would operate under interim funds control processes. The FY 2003 Appropriations Act provides the CFO with the authority to make such determinations.

The HUD Handbook requires that each allotment holder annually recertify funds control systems. While FHA has not submitted updated funds control plans for the past two years and may not be in

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compliance with the Handbook – the requirements of which FHA believes the CFO has the authority to waive – this does not constitute non-compliance with laws and regulations. Therefore, FHA respectfully requests that the OIG reported lack of FHA's funds control plans be removed from the Compliance with Laws and Regulations section.

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Appendix C
UKW's Assessment of Management's Response to Recommendations

UKW has obtained and reviewed FHA management's response to the findings and recommendations made in connection with our audit of FHA's 2006 Principal Financial Statements, which is included as Appendix B. Our assessment of management's responses is discussed below.

Assessment of management's response to reportable condition No. 1:

We believe management's proposed actions are responsive to our recommendations. However management should enhance the specific components of its transaction level funds control procedures as outlined in its response and highlight how and where (i.e. FHASL) the key funds control points are at the various levels (e.g. obligation level, commitment level, allotment level, etc.) and how the control of funds is reported.

Assessment of management's response to reportable condition No. 2:

We believe management's proposed actions are responsive to our recommendations.

Assessment of management's response to reportable condition No. 3:

Although FHA did provide UKW with evidence of the contract modifications to the HITS contract to be effective for FY2007, UKW has indicated to FHA management that since the system backup plans were inadequate for the full fiscal year under audit that the finding cannot be considered to be resolved. We have, however, revised our recommendation to address the implementation of the contract modification for FY2007.

Assessment of management's response to reported instance of non-compliance with laws and regulations:

We acknowledge the provision of the Appropriation Act that allowed FHA to operate under the interim funds control processes. However, we do not believe this waiver was intended to be in effect beyond FY2003. We also appreciate the efforts undertaken by FHA to improve its funds control procedures. However, we do not believe these efforts have been part of a coordinated comprehensive annual plan to meet the funds control improvement objectives as anticipated by the FY2003 Appropriations Act. Given the significance of the potential impact of potential Anti-deficiency Act violations, we continue to believe this matter is reportable.

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Appendix D
Status of Prior Year Findings and Recommendations

Our assessment of the current status of reportable conditions and material weaknesses identified in prior year audits is presented below:

Prior Finding/Recommendation	***Type***	***Fiscal Year 2006 Status***
1a. The Director of the FHA Office of Evaluation should evaluate the information provided from the TOTAL scorecard process and the current actuarial review relating to down payment assistance and determine the impact of incorporating these additional loan risk attributes directly into the MMI fund cash flow modeling process to ensure future changes to the composition of borrowers result in a corresponding timely change in projected claim rates.	2005 Material Weakness	Resolved. FHA has incorporated down payment assistance as a risk factor in the 2005 MMI fund Actuarial Review. FHA also incorporated a sample of borrower credit history (FICO credit scores) into the claims and prepayment rate calculations in the FY 2006 MMI Fund Actuarial Review and Loan Guarantee Liability calculation.
1b. The Director for the Housing Office of Single Family Program Development, in coordination with the Director of the Office of Evaluation, should determine whether poor underwriting ratings correlate to higher claim rates for those lenders under the revised PETR monitoring process.		Resolved. FHA determined that there was no correlation between the propensity to receive unacceptable PETR ratings and default claim rates. In FY 2006, FHA revised the PETR rating process using a more risk-based approach which incorporates added subjective factors than previously used. FHA has significantly enhanced the documented guidance provided to PETR contractors in FY 2006, although there are still inconsistencies in ratings between the PETR contractors and FHA's Quality Assurance Processing and Underwriting Division. Issue has been included in the FY2006 Management Letter.
2a. FHA Director of the Office of Evaluation should expand the validation process developed in 2005 to use the prior year comparisons of projected and actual cash flows to develop management's expectations for gross cash flows and other key ratios to be produced by the upcoming reestimation process.	2005 Material Weakness	Resolved. FHA amended the Cash Flow Model Configuration Management Plan and revised the validation reports to assess the accuracy of the projected cash flow estimates. The Mark-to-Market Model has been modified to improve estimates of future cash flows.

Appendix D
Status of Prior Year Findings and Recommendations

2b. FHA Director of the Office of Evaluation should expand the information on the results of the Mark-to-Market modeling process provided to approving officials to improve their ability to evaluate the reasonableness of the resulting calculations. At a minimum, such information should include: (a) the number and unpaid principal balance of projects eligible for Mark-to-Market restructuring, (b) the number and amount of projects resulting in full or partial claims, (c) the net present values of those claims, (d) the related premium and recovery amounts that make up the net liability and (e) key ratios to assist management in evaluating the reasonableness of the components of the calculated liability as well as the net balance.		Resolved. See 2a above.
2c. The FHA Director of the Office of Evaluation should expand the information on the results of the HECM modeling process provided to approving officials to improve their ability to evaluate the reasonableness of the resulting calculations. At a minimum, such information should include: (a) summary information on each type of cash flow, (b) the effect of changes in sensitive model assumptions on each type of cash flow, (c) the net present value of each of these types of cash flows, and (d) key ratios to assist management in evaluating the reasonableness of the components of the calculated liability as well as the net balance.		Resolved. See 2a above. The expanded validation report included an analysis of the results of the HECM modeling process.

Appendix D
Status of Prior Year Findings and Recommendations

2d. The FHA Director of the Office of Evaluation, in coordination with the Deputy Assistant Secretary for Finance and Budget, should expand the year-end model review process to include a comparison and analysis of management's expectations developed above with the results of the current year modeling process and prior year cash flow calculations. This, would, at a minimum, include reviewing the effect of current year changes to the data model, sensitive assumptions, gross cash flow information and results and documentation of management's explanation for any significant variances between the expected balances and the current model calculations.		Resolved. FHA performed validation testing using FY2005 data to support the assumptions and results. Any discrepancies in prior year assumptions are investigated and corrected by management.
3. FHA must continue to enhance the management of controls over its portfolio of integrated insurance and financial systems.	2005 Reportable Condition	See 2006 Reportable Condition Finding No. 2. Certain issues have been included in the FY2006 Management Letter.
3a. Ensure the HITS contract is updated to include FHASL as a mission critical application.		Repeat finding. See Reportable Condition No.3.
3b.Ensure the updated Security Plan for FHASL contains appropriate data integrity, availability and confidentiality classifications as required by OMB and NIST standards.		Resolved.
3c. Develop an FHASL Risk Assessment document in compliance with NIST guidance.		Resolved.
3d. Develop a contingency plan for the FHASL application and test the plan on an annual basis.		Resolved.

Appendix D
Status of Prior Year Findings and Recommendations

3e. Ensure that the data center security plan is updated to reflect the current operating environment.		Resolved.
3f. Ensure the security logs for systems managed under the HITS contract are reviewed and properly documented.		Resolved.
3g. Ensure the FY2006 FHA systems project plan is consistent with the HUD Enterprise Architecture integration plan.		Resolved. Issue has been included in the FY2006 Management Letter.

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2006 and 2005
(Dollars in Millions)

	2006	2005
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 10,568	$ 9,705
Investments (Note 4)	22,012	22,745
Other Assets (Note 7)	24	54
Total Intragovernmental	32,604	32,504
Investments (Note 4)	98	201
Accounts Receivable, Net (Note 5)	168	302
Loans Receivable and Related Foreclosed Property, Net (Note 6)	4,283	4,057
Other Assets (Note 7)	140	97
TOTAL ASSETS	**$ 37,293**	**$ 37,161**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 9)	$ 6,258	$ 7,548
Other Liabilities (Note 10)	2,486	772
Total Intragovernmental	8,744	8,320
Accounts Payable (Note 8)	396	597
Loan Guarantee Liability (Note 6)	3,482	4,584
Debentures Issued to Claimants (Note 9)	95	132
Other Liabilities (Note 10)	577	373
TOTAL LIABILITIES	**13,294**	**14,006**
NET POSITION		
Unexpended Appropriations (Note 16)	594	609
Cumulative Results of Operations	23,405	22,546
TOTAL NET POSITION	23,999	23,155
TOTAL LIABILITIES AND NET POSITION	**$ 37,293**	**$ 37,161**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION

(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)

CONSOLIDATED STATEMENTS OF NET COST

For the periods ended September 30, 2006 and 2005

(Dollars in Millions)

	2006	2005
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 387	$ 405
Less: Intragovernmental Earned Revenue (Note 13)	1,334	1,344
Intragovernmental Net Costs	(947)	(939)
Gross Costs with the Public (Note 12)	1,135	1,243
Less: Earned Revenue from the Public (Note 13)	94	41
Net Costs with the Public	1,041	1,202
NET MMI/CMHI PROGRAM COST (SURPLUS)	**$ 94**	**$ 263**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 147	$ 127
Less: Intragovernmental Earned Revenue (Note 13)	188	147
Intragovernmental Net Costs	(41)	(20)
Gross Costs with the Public (Note 12)	(2,049)	(989)
Less: Earned Revenue from the Public (Note 13)	85	322
Net Costs with the Public	(2,134)	(1,311)
NET GI/SRI PROGRAM COST (SURPLUS)	**(2,175)**	**(1,331)**
NET COST (SURPLUS) OF OPERATIONS	**$ (2,081)**	**$ (1,068)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the periods ended September 30, 2006 and 2005
(Dollars in Millions)

	2006 Cumulative Results of Operations	2006 Unexpended Appropriations	2005 Cumulative Results of Operations	2005 Unexpended Appropriations
BEGINNING BALANCES	**$ 22,546**	**$ 609**	**$ 20,470**	**$ 699**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)	-	1,281	-	1,987
Other Adjustments (Note 16)	-	(83)	-	(81)
Appropriations Used (Note 16)	1,178	(1,178)	1,859	(1,859)
Transfers-Out (Note 15 and 16)	(731)	(35)	(577)	(137)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(1,692)	-	(297)	-
Imputed Financing (Note 12)	23	-	23	-
Other (Note 15)	-	-	-	-
TOTAL FINANCING SOURCES	**(1,222)**	**(15)**	**1,008**	**(90)**
NET (COST) SURPLUS OF OPERATIONS	**2,081**	-	**1,068**	-
ENDING BALANCES	**$ 23,405**	**$ 594**	**$ 22,546**	**$ 609**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the periods ended September 30, 2006 and 2005
(Dollars in Millions)

	2006 Budgetary	2006 Non-Budgetary	2005 Budgetary	2005 Non-Budgetary
BUDGETARY RESOURCES				
Unobligated Balance, brought forward, October 1	$ 23,602	$ 5,891	$ 23,978	$ 4,609
Recoveries of prior year unpaid obligations	97	6	20	39
Budget Authority:				
Appropriations	1,281	-	1,987	-
Borrowing authority	9	888	(9)	1,175
Spending authority from offsetting collections (gross):				
Earned	-	-	-	-
Collected	2,636	11,470	2,757	11,722
Change in receivables from Federal sources	(55)	(46)	13	(87)
Change in unfilled customer order w/o advance	-	-	-	-
Anticipated for rest of year, without advance	-	-	-	-
Permanently not available	(152)	(2,186)	(311)	(1,215)
TOTAL BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 28,435	$ 16,243
STATUS OF BUDGETARY RESOURCES				
Obligations incurred, Direct	$ 5,028	$ 8,990	$ 4,833	$ 10,352
Unobligated balance-Apportioned	161	2,132	77	2,649
Unobligated balance-Not available	22,229	4,901	23,525	3,242
TOTAL STATUS OF BUDGETARY RESOURCES	$ 27,418	$ 16,023	$ 28,435	$ 16,243
Change in Obligated Balances				
Obligated balance, net:				
Unpaid obligations, brought forward, October 1	$ 1,067	$ 1,263	$ 991	$ 1,264
Uncollected customer payments from Federal sources,	(262)	(52)	(248)	(139)
Total, unpaid obligated balance, brought forward, net	805	1,211	743	1,125
Obligations incurred	5,028	8,990	4,833	10,352
Gross outlays	(5,018)	(8,871)	(4,737)	(10,314)
Recoveries of prior-year unpaid obligations, actual	(97)	(6)	(20)	(39)
Change in uncollected customer payments-Federal sources	55	46	(13)	87
	773	1370	806	1,211
Obligated balance, net, end of period:				
Unpaid obligations	980	1,377	1,067	1,263
Uncollected customer payments from Federal sources	(207)	(7)	(261)	(52)
Total, unpaid obligated balance, net, end of period	773	1370	806	1,211
Net outlays:				
Gross outlays	5,018	8,871	4,737	10,314
Offsetting collections	(2,636)	(11,470)	(2,757)	(11,722)
Less: Distributed offsetting receipts	677	-	474	-
NET OUTLAYS	$ 1,705	$ (2,599)	$ 1,506	$ (1,408)

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF FINANCING
For the periods ended September 30, 2006 and 2005
(Dollars in Millions)

	2006	2005
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 14,018	$ 15,185
Spending Authority from Offsetting Collections and Recoveries	(14,108)	(14,464)
Offsetting Receipts	(677)	(474)
Transfers Out	(1,692)	(297)
Imputed Financing from Costs Absorbed by Others	23	23
Other	-	-
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**$ (2,436)**	**$ (27)**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods and Services Ordered but not yet Provided	$ (124)	$ (57)
Resources that Fund Expenses Recognized in Prior Periods	(3,768)	(3,161)
Budgetary Offsetting Collections and Receipts that Do Not Affect the Net Cost (Surplus) of Operations	13,104	13,158
Resources that Finance the Acquisition of Assets	(6,994)	(10,114)
Transfer Out to HUD without Reimbursement Related to Salary and Expense Payments	(234)	(233)
Other Resources or Adjustments that do not Affect the Net Cost (Surplus) of Operations	(40)	(165)
TOTAL RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS	**$ 1,944**	**$ (572)**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**$ (492)**	**$ (599)**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Reestimate of Credit Subsidy Expense	$ 2,683	$ 2,552
Downward Reestimate of Credit Subsidy Expense	(2,268)	(402)
Changes in Loan Loss Reserve Expense	(739)	(1,138)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(5)	(200)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(1,380)	(1,304)
Gains or Losses on Sales of Credit Program Assets	54	276
Other	66	(253)
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**$ (1,589)**	**$ (469)**
NET COST (SURPLUS) OF OPERATIONS	**$ (2,081)**	**$ (1,068)**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2006

Note 1. Significant Accounting Policies

Entity and Mission

The Federal Housing Administration (FHA) was established under the National Housing Act of 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. While FHA was established as a separate Federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created in 1965. FHA does not maintain a separate staff or facilities; its operations are conducted, along with other Housing activities, by HUD organizations. FHA is headed by HUD's Assistant Secretary for Housing/Federal Housing Commissioner, who reports to the Secretary of HUD. FHA's activities are included in the Housing section of the HUD budget.

FHA administers a wide range of activities to make mortgage financing more accessible to the home-buying public and to increase the availability of affordable housing to families and individuals, particularly to the nation's poor and disadvantaged. FHA insures private lenders against loss on mortgages, which finance Single Family homes, Multifamily projects, health care facilities, property improvements, and manufactured homes. The objectives of the activities carried out by FHA relate directly to developing affordable housing.

FHA categorizes its activities as Single Family, Multifamily, or Title I. Single Family activities support basic home ownership; Multifamily activities support high-density housing and medical facilities; Title I activities support manufactured housing and property improvement.

FHA organizes its operations into two overall program types – MMI/CMHI and GI/SRI. These program types are composed of four major funds. The Mutual Mortgage Insurance fund (MMI), FHA's largest fund, provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI fund that are not required for operating expenses and losses or to build equity. The Cooperative Management Housing Insurance fund (CMHI), another mutual fund, provides mortgage insurance for management-type cooperatives. The General Insurance fund (GI), provides a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals. The Special Risk Insurance fund (SRI) provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

Basis of Accounting

The principal financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to Federal agencies as promulgated by the Federal Accounting Standards Advisory Board (FASAB). The recognition and measurement of budgetary resources and their status for purposes of preparing the Combined Statement of Budgetary Resources, is based on concepts and guidance provided by the Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*. The format of the SBR is derived from the SF 133 Report on Budget Execution and Budgetary Resources. Beginning with fiscal year 2006, OMB revised its format of the SF 133 as described in OMB Circular No. A-11. The corresponding changes to the SBR format resulted in the reclassification of the prior period comparative data.

Basis of Consolidation

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSs) designated to FHA, which consist of two principal general program funds, six revolving funds, two general funds and a deposit fund. All inter-fund accounts receivable, accounts payable, transfers in and transfers out within these TAFSs have been eliminated to prepare the consolidated balance sheets, statements of net cost, statements of changes in net position and statements of financing. The statements of budgetary resources are prepared on a combined basis as allowed by OMB Circular A-136 *Financial Reporting Requirements*.

Use of Estimates

The preparation of the principal financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Amounts reported for the allowance for subsidy related to net loans receivable and related foreclosed property and the loan guarantee liability represent FHA's best estimates based on pertinent information available. To calculate these estimates, FHA uses cash flow models with various assumptions to make reasonable projections of future performance. These assumptions are calculated using historical data, as well as estimated using current and forecasted program and economic assumptions.

Certain programs have higher risks due to inherent programmatic risk factors as well as increased chances of fraudulent activities perpetrated against FHA. FHA accounts for these risks through the assumptions used in the liabilities for loan guarantee estimates. FHA develops the assumptions based on historical performance and management's judgments about future loan performance.

Fund Balance with U.S. Treasury

Fund balance with U.S. Treasury consists of amounts collected and available to fund payments for expenses and of amounts collected but unavailable until authorizing legislation is enacted (see Notes 2 and 3).

Credit Reform Accounting

The Federal Credit Reform Act of 1990 (FCRA) establishes the use of the program, financing, general fund receipt and capital reserve accounts for tracking activity related to loan guarantees committed and direct loans obligated after September 30, 1991 (Credit Reform). It also establishes the liquidating account for activity relating to any loan guarantees committed and direct loans obligated before October 1, 1991 (pre-Credit Reform). These accounts are classified as either budgetary or non-budgetary in the Combined Statements of Budgetary Resources. The budgetary accounts include the program, capital reserve and liquidating accounts. The non-budgetary accounts consist of the credit reform financing accounts.

The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account at the time the loan is disbursed or guaranteed. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that is used to record all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It includes loan disbursements, loan repayments and fees, premiums, recoveries, claims, borrowing from the U.S. Treasury, interest, negative subsidy and the subsidy cost received from the program account.

The general fund receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward reestimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the FHA's credit programs. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to the U.S. Treasury general fund. The FHA general fund receipt account of the GI and SRI funds are in this category.

In order to resolve the different requirements between the FCRA and the National Affordable Housing Act of 1990 (NAHA), OMB instructed FHA to create the capital reserve account to record the MMI/CMHI negative subsidy and subsequent downward reestimates. Specifically, the NAHA required that FHA's MMI fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, to ensure that the calculated Capital Ratio reflects the actual strength of the MMI fund, the resources of the capital reserve account, which are considered FHA assets, are included in the calculation of the MMI fund's economic net worth. At the end of fiscal year 1995, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimated the fiscal year 2006 Capital Ratio to be 6.82 percent. The fiscal year 2005 Capital Ratio was projected to be 6.02 percent.

The liquidating account is a budget account that is used to record activity related to pre-Credit Reform direct loans or loan guarantees. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances remaining in the GI and SRI liquidating funds at year-end are transferred to the U.S. Treasury's general fund. Consequently, in the event that resources in the GI/SRI liquidating account are otherwise insufficient to cover the payments for obligations or commitments, the FCRA provides that the GI/SRI liquidating account can receive permanent indefinite authority to cover any resource shortages.

Investments

FHA investments include investments in U.S. Treasury securities and investments in private-sector entities where FHA is a member with other parties under the Accelerated Claims Disposition Demonstration program (see Note 4).

Under current legislation, FHA invests available resources in excess of its current needs (in MMI/CMHI funds) in non-marketable market-based U.S. Treasury securities. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. Investments are presented at acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized monthly in interest income on investments in U.S. Treasury securities on the effective interest rate basis.

The Departments of Veterans Affairs and Housing and Urban Development Appropriations Act of 1999 and Section 601 of the Independent Agencies Act of 1999 provide FHA with new flexibility in reforming its single family claims and property disposition activities. In accordance with these Acts, FHA implemented the Accelerated Claims Disposition Demonstration program (the 601 program) to shorten the claim filing process, obtain higher recoveries from its defaulted guaranteed loans, and support the Office of Housing's mission of keeping homeowners in their home. To achieve these objectives, FHA transfers assigned mortgage notes to private sector entities in exchange for cash and equity interest. The servicing and disposition of the mortgage notes are performed by the private-sector entities whose primary mission is dedicated to these types of activity.

With the transfer of assigned mortgage notes under the 601 program, FHA obtains ownership interest in the private-sector entities. This level of ownership interest enables FHA to exercise significant influence over the operating and financial policies of the entities. Accordingly, to comply with the requirement of Opinion No. 18 issued by the Accounting Principles Board (APB 18), FHA uses the equity method of accounting to measure the value of its investments in these entities. The equity method of accounting requires FHA to record its investments in the entities at cost initially. Periodically, the carrying amount of the investments is adjusted for cash distributions to FHA and for FHA's share of the entities' earnings or losses.

Loans Receivable and Related Foreclosed Property, Net

FHA's loans receivable include mortgage notes assigned (MNA), also described as Secretary-held notes, and purchase money mortgages (PMM). Under the requirements of the FCRA, PMM notes are considered to be direct loans while MNA notes are considered to be defaulted guaranteed loans. The PMM loans are generated from the sales on credit of FHA's foreclosed properties to qualified non-profit organizations. The MNA notes are created when FHA pays the lenders for claims on defaulted guaranteed loans and takes assignment of the defaulted loans for direct collections. In addition, Multifamily and Single Family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

In accordance with the FCRA and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, Credit Reform direct loans, defaulted guaranteed loans and foreclosed property are reported at the net present value of expected cash flows associated with these assets, primarily estimated proceeds less selling and maintenance costs. The difference between the cost of these loans and property and the net present value is called the Allowance for Subsidy cost. Pre-Credit Reform loans receivable and foreclosed property in inventory are recorded at net realizable value, which is based on historical recovery rates net of any selling expenses (see Note 6).

General Property, Plant and Equipment

FHA does not maintain separate facilities. HUD purchases and maintains all property, plant and equipment used by FHA, along with other Office of Housing activities.

Current HUD policy concerning SFFAS No. 10 *Accounting for Internal Use Software* indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy.

Loan Guarantee Liability

The net potential future losses related to FHA's central business of providing mortgage insurance are reflected in the Loan Guarantee Liability in the consolidated balance sheets. As required by SFFAS No. 2, the Loan Guarantee Liability includes the Credit Reform related Liabilities for Loan Guarantees (LLG) and the pre-Credit Reform Loan Loss Reserve (LLR) (see Note 6).

The LLG is calculated as the net present value of anticipated cash outflows and cash inflows. Anticipated cash outflows include lender claims arising from borrower defaults, (i.e., claim payments), premium refunds, property costs to maintain foreclosed properties arising from future defaults and selling costs for the properties. Anticipated cash inflows include premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes.

FHA records loss estimates for its single family LLR (includes MMI and GI/SRI) to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net cash flows (cash outflows less cash inflows), FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates for its multifamily LLR (includes CMHI and GI/SRI) to provide for anticipated outflows less anticipated inflows. Using the net present value of claims less premiums, fees, and recoveries, FHA computes an estimate based on conditional claim rates, prepayment rates, and recovery assumptions based on historical experience.

Unearned Premiums

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA's MMI fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other funds charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating account on a straight-line basis throughout the year. Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amounts reported in the consolidated balance sheets.

Appropriations and Monies Received from Other HUD Programs

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of GI and SRI funds. For Credit Reform loan guarantees, appropriations to the GI and SRI funds are provided at the beginning of each fiscal year to cover estimated losses on insured loans during the year. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance any shortages of resources needed for operations.

Monies received from other HUD programs, such as interest subsidies and rent supplements are recorded as revenue for the liquidating accounts when services are rendered. Monies received for the financing accounts are recorded as additions to the LLG or the Allowance for Subsidy (AFS) when collected.

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identifies each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs was $23 million for both fiscal years 2006 and 2005, and is included in FHA's financial statements as an imputed cost in the Consolidated Statements of Net Cost, and an imputed financing in the Consolidated Statements of Changes in Net Position and the Consolidated Statements of Financing.

In a separate effort, FHA conducts time allocation surveys of all Office of Housing operational managers. These surveys determine FHA's direct personnel costs associated with the Housing Salaries and Expenses (S&E) transfer to HUD and where to allocate these costs between the MMI/CMHI and GI/SRI programs. The HUD Chief Financial Officer (CFO) office also conducts surveys to determine how the department's fiscal year overhead, Office of Inspector General, and Working Capital Fund costs, which are paid for by S&E transfer, should be accounted for by responsibility segments. This data is an integral part of the FHA direct cost S&E allocation prepared for financial statement reporting.

Distributive Shares

As mutual funds, excess revenues in the MMI Fund and CMHI Fund may be distributed to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI fund, other than those already declared by the Secretary, until the fund meets certain Capital Ratio requirements.

Although the Capital Ratio requirement has been met since September 30, 1995, no distributive shares have been declared from the MMI fund because legislation is not yet enacted.

Liabilities Covered by Budgetary Resources

Liabilities of federal agencies are required to be classified as those covered and not covered by budgetary resources, as defined by OMB Circular A-136, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury (for post-1991 loan guarantees) or to draw on permanent indefinite appropriations (for pre-1992 loan guarantees) to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

Note 2. Non-entity Assets

Non-entity assets consist of assets that belong to other entities but are included in FHA's consolidated balance sheets. To reflect FHA's net position accurately, these non-entity assets are offset by various liabilities. FHA's non-entity assets as of September 30, 2006 and 2005 are as follows:

(Dollars in millions)

		2006		2005
Intragovernmental:				
Fund Balance with U.S. Treasury	$	731	$	1,272
Investments in U.S. Treasury Securities		5		4
Total Intragovernmental		736		1,276
Other Assets		111		95
Total Non-entity Assets		847		1,371
Total Entity Assets		36,446		35,790
Total Assets	$	**37,293**	$	**37,161**

FHA's non-entity assets consist of FHA's U.S. Treasury deposit of negative credit subsidy in the GI/SRI general fund receipt account and of escrow monies collected by FHA from the borrowers of its loans.

According to the FCRA, FHA transfers negative credit subsidy from new endorsements and downward credit subsidy reestimates from the GI/SRI financing account to the GI/SRI general fund receipt account. At the beginning of each fiscal year, fund balance in the GI/SRI general fund receipt account is transferred into the U.S. Treasury's general fund.

Other assets consisting of escrow monies collected from FHA borrowers are either deposited at the U.S. Treasury or Minority-owned banks or invested in U.S. Treasury securities. Subsequently, FHA disburses these escrow monies to pay for property taxes, property insurance or maintenance expenses on behalf of the borrowers.

Note 3. Fund Balance with U.S. Treasury

FHA's fund balance with U.S. Treasury was composed of the following as of September 30, 2006 and 2005:

(Dollars in millions)

		2006		2005
Fund Balances:				
Revolving Funds	$	9,393	$	8,044
Appropriated Funds		408		460
Other Funds		767		1,201
Total	$	**10,568**	$	**9,705**
Status of Fund Balance with U.S. Treasury:				
Unobligated Balance:				
Available		2,292		2,724
Unavailable		5,919		4,651
Obligated Balance not yet Disbursed		2,357		2,330
Total	$	**10,568**	$	**9,705**

Revolving Funds

FHA's revolving funds include the liquidating and financing accounts as required by the FCRA. These funds are created to finance a continuing cycle of business-like operations in which the fund charges for the sale of products or services. These funds also use the proceeds to finance spending, usually without requirement of annual appropriations.

Appropriated Funds

FHA's appropriated funds consist of the program accounts created by the FCRA. Annual or multi-year program accounts expire at the end of the time period specified in the authorizing legislation. For the subsequent five fiscal years after expiration, the resources are available only to liquidate valid obligations incurred during the unexpired period. Adjustments are allowed to increase or decrease valid obligations incurred during the unexpired period that were not previously reported. At the end of the fifth expired year, the annual and multi-year program accounts are cancelled and any remaining resources are returned to the U.S. Treasury.

Other Funds

FHA's other funds include the general fund receipt accounts established under the FCRA. Additionally, included with these funds is the capital reserve account that is used to retain the MMI/CMHI negative subsidy and downward credit subsidy reestimates transferred from the financing account. If subsequent upward credit subsidy reestimates are calculated in the financing account or there is shortage of budgetary resources in the liquidating account, the capital reserve account will return the retained negative subsidy to the financing account or transfer the needed funds to the liquidating account, respectively.

Status of Fund Balance with U.S. Treasury

Unobligated Fund Balance with U.S. Treasury represents that portion of the Fund Balance with U.S. Treasury that has not been obligated to purchase goods or services either because FHA has not received apportionment authority from OMB to use the resources (unavailable unobligated balance) or because FHA has not obligated the apportioned resources (available unobligated balance). Fund Balance with U.S. Treasury that is obligated, but not yet disbursed, consists of resources that have been obligated for goods or services but not yet disbursed either because the ordered goods or services have not been delivered or because FHA has not yet paid for goods or services received by the end of the fiscal year.

Note 4. Investments

Investment in U.S. Treasury Securities

As discussed in Note 1, all FHA investments in Treasury securities are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2006 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 21,715	$ 22,030	$ (223)	$ 21,807	$ 21,987
GI/SRI Investments	6	6	-	6	6
Subtotal	21,721	22,036	(223)	21,813	21,993
MMI/CMHI Accrued Interest	-	-	-	199	-
Total	**$ 21,721**	**$ 22,036**	**$ (223)**	**$ 22,012**	**$ 21,993**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2005 were as follows:

(Dollars in millions)

	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 22,346	$ 22,642	$ (161)	$ 22,481	$ 22,957
GI/SRI Investments	4	4	-	4	4
Subtotal	22,350	22,646	(161)	22,485	22,961
MMI/CMHI Accrued Interest	-	-	-	260	-
Total	**$ 22,350**	**$ 22,646**	**$ (161)**	**$ 22,745**	**$ 22,961**

Investments in Private-Sector Entities

The following table presents financial data on FHA's investments in private-sector entities as of September 30, 2006 and 2005:

(Dollars in millions)

	Beginning Balance	New Acquisitions	Share of Earnings or Losses	Return of Investment	Other Adjustments	Ending Balance
2006	$ 201	$ 49	$ 15	$ (167)	$ -	$ 98
2005	$ 122	$ 252	$ 58	$ (231)	$ -	$ 201

The condensed, audited financial information related to these private-sector entities as of December 31, 2005 and 2004 are as follows:

(Dollars in millions)	**2006**	**2005**
Total assets, primarily mortgage loans	$ 422	$ 499
Liabilities	3	3
Partners' capital	419	496
Total liabilities and partners' capital	$ 422	$ 499
Revenues	184	235
Expenses	(20)	(31)
Net Income	$ 164	$ 204

Note 5. Accounts Receivable, Net

Accounts receivable, net, as of September 30, 2006 and 2005 are as follows:

	Gross		**Allowance**		**Net**	
(Dollars in millions)	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**
From the Public:						
Receivables related to credit program assets	$ 73	$ 30	$ (4)	$ (4)	$ 69	$ 26
Premiums receivable	50	119	-	-	50	119
Miscellaneous receivables	127	235	(78)	(78)	49	157
Total	**$ 250**	**$ 384**	**$ (82)**	**$ (82)**	**$ 168**	**$ 302**

Receivables Related to Credit Program Assets

These receivables represent sale proceeds receivable and rents receivable from FHA's foreclosed properties. The sale proceeds receivable should be differentiated from the PMM notes receivables, which are created by the sales of FHA's foreclosed properties on credit to qualifying non-profit organizations.

Premiums Receivable

These amounts represent the up-front and periodic premiums due to FHA from the mortgagors at the end of the reporting period. The details of FHA premium structure are discussed in Note 13 – Earned Revenue/Premium Revenue.

Miscellaneous Receivables

Miscellaneous receivables include late charges and penalties receivable on premiums receivable, generic debt receivables, refunds receivable from overpayments of claims and distributive shares and other immaterial receivables.

Allowance for Loss

The allowance for loss for these receivables is calculated based on FHA's historical loss experience and management's judgment concerning current economic factors.

Note 6. Direct Loans and Loan Guarantees, Non-Federal Borrowers

FHA Direct Loan and Loan Guarantee Programs and the related loans receivable, foreclosed property, and loan guarantee liability as of September 30, 2006 and 2005 are as follows:

Direct Loan and Loan Guarantee Programs Administered by FHA Include:

MMI/CMHI Direct Loan Program
GI/SRI Direct Loan Program
MMI/CMHI Loan Guarantee Program
GI/SRI Loan Guarantee Program

Direct Loans Obligated Prior to Fiscal Year 1992 (Allowance for Loss Method):

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FY 2006:					
MMI/CMHI	$ 3	$ -	$ (2)	$ -	$ 1
GI/SRI	14	3	(5)	-	12
Total	**$ 17**	**$ 3**	**$ (7)**	**$ -**	**$ 13**
FY 2005:					
MMI/CMHI	$ 3	$ -	$ (1)	$ -	$ 2
GI/SRI	14	3	(6)	-	11
Total	**$ 17**	**$ 3**	**$ (7)**	**$ -**	**$ 13**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Direct Loans
FY 2006:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	-
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**
FY 2005:					
MMI/CMHI	$ 1	$ -	$ -	$ (3)	$ (2)
GI/SRI	-	-	-	-	-
Total	**$ 1**	**$ -**	**$ -**	**$ (3)**	**$ (2)**

Total Amount of Direct Loans Disbursed (Post-1991):

(Dollars in millions)

Direct Loan Programs	FY 2006	FY 2005
MMI/CMHI	$ 3	$ 2
GI/SRI	-	-
Total	**$ 3**	**$ 2**

Defaulted Guaranteed Loans from Pre-1992 Guarantees (Allowance for Loss Method):

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2006:					
MMI/CMHI	$ 4	$ -	$ (1)	$ 6	$ 9
GI/SRI	2,974	135	(818)	8	2,299
Total	$ **2,978**	$ **135**	$ **(819)**	$ **14**	$ **2,308**
FY 2005:					
MMI/CMHI	$ 5	$ -	$ (1)	$ 16	$ 20
GI/SRI	2,968	140	(845)	8	2,271
Total	$ **2,973**	$ **140**	$ **(846)**	$ **24**	$ **2,291**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2006:					
MMI/CMHI	$ 341	$ -	$ 2,539	$ (1,257)	$ 1,623
GI/SRI	576	48	350	(633)	341
Total	$ **917**	$ **48**	$ **2,889**	$ **(1,890)**	$ **1,964**
FY 2005:					
MMI/CMHI	$ 343	$ 1	$ 2,405	$ (1,441)	$ 1,308
GI/SRI	655	60	387	(655)	447
Total	$ **998**	$ **61**	$ **2,792**	$ **(2,096)**	$ **1,755**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value		Amount of Outstanding Principal Guaranteed	
FY 2006				
Guaranteed Loans Outstanding:				
MMI/CMHI	$	346,658	$	317,249
GI/SRI		87,412		78,522
Total	**$**	**434,070**	**$**	**395,771**
FY 2005				
Guaranteed Loans Outstanding:				
MMI/CMHI	$	364,444	$	335,568
GI/SRI		89,928		80,893
Total	**$**	**454,372**	**$**	**416,461**
FY 2006				
New Guaranteed Loans Disbursed:				
MMI/CMHI	$	51,780	$	50,585
GI/SRI		9,846		9,140
Total	**$**	**61,626**	**$**	**59,725**
FY 2005				
New Guaranteed Loans Disbursed:				
MMI/CMHI	$	55,287	$	54,823
GI/SRI		11,004		10,950
Total	**$**	**66,291**	**$**	**65,773**

Home Equity Conversion Mortgage Loans Outstanding (not included in balances above):

(Dollars in millions)

Loan Guarantee Programs			Current Year Endorsements	Cumulative			
					Current Outstanding Balance		Maximum Potential Liability
FY 2006	GI/SRI	$	17,994	$	18,295	$	35,878
FY 2005	GI/SRI	$	8,925	$	10,615	$	20,760

Loan Guarantee Liability, Net:

(Dollars in millions) Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims (LLR)	Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG)	Total Loan Guarantee Liability, Net
FY 2006:			
MMI/CMHI	$ 51	$ 2,828	$ 2,879
GI/SRI	447	156	603
Total	**$ 498**	**$ 2,984**	**$ 3,482**
FY 2005:			
MMI/CMHI	$ 53	$ 1,803	$ 1,856
GI/SRI	1,164	1,564	2,728
Total	**$ 1,217**	**$ 3,367**	**$ 4,584**

Subsidy Expense for Loan Guarantees by Program and Component:

(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2006:				
MMI/CMHI	$ 818	$ (2,076)	$ 378	$ (880)
GI/SRI	647	(1,138)	-	(491)
Total	$ **1,465**	$ **(3,214)**	$ **378**	$ **(1,371)**
FY 2005:				
MMI/CMHI	$ 1,201	$ (2,516)	$ 271	$ (1,044)
GI/SRI	709	(891)	-	(182)
Total	$ **1,910**	$ **(3,407)**	$ **271**	$ **(1,226)**

(Dollars in millions)

Subsidy Expense for Modifications and Reestimates	Total Modifications	Technical Reestimates
FY 2006:		
MMI/CMHI	$ (9)	$ 1,531
GI/SRI	-	(1,110)
Total	**$ (9)**	**$ 421**
FY 2005:		
MMI/CMHI	$ -	$ 1,933
GI/SRI	(78)	(12)
Total	**$ (78)**	**$ 1,921**

(Dollars in millions)

Total Loan Guarantee Subsidy Expense	2006	2005
MMI/CMHI	**$** 642	$ 889
GI/SRI	(1,601)	(271)
Total	**$ (959)**	**$ 618**

Subsidy Rates for Loan Guarantees by Program and Component:

(Percentage)	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2006 Cohort:				
MMI/CMHI	1.58	(4.01)	0.73	(1.70)
GI/SRI	2.32	(4.09)	-	(1.77)
Budget Subsidy Rates for Loan Guarantees of FY 2005 Cohort:				
MMI/CMHI	2.05	(4.30)	0.46	(1.79)
GI/SRI	3.51	(4.41)	-	(0.90)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2006 LLR	2006 LLG	2005 LLR	2005 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 1,217**	**$ 3,367**	**$ 2,349**	**$ 2,725**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)	-	1,465	-	1,910
Fees and Other Collections	-	(3,214)	-	(3,407)
Other Subsidy Costs	-	378	-	271
Total of the above subsidy expense components	**-**	**(1,371)**	**-**	**(1,226)**
Adjustments:				
Fees Received	-	2,819	-	2,483
Foreclosed Property and Loans Acquired	-	4,011	-	5,753
Claim Payments to Lenders	-	(6,296)	-	(8,503)
Interest Accumulation on the Liability Balance	-	35	-	(57)
Other	-	13	-	42
Ending Balance before Reestimates	**1,217**	**2,578**	**2,349**	**1,217**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate:				
Subsidy Expense Component	(719)	(677)	(1,132)	1,921
Interest Expense Component	-	(269)	-	199
Adjustment of prior years' credit subsidy reestimates		1,352		30
Total Technical/Default Reestimate	**(719)**	**406**	**(1,132)**	**2,150**
Ending Balance of the Loan Guarantee Liability	**$ 498**	**$ 2,984**	**$ 1,217**	**$ 3,367**

Administrative Expense:

(Dollars in millions)

	2006	2005
MMI/CMHI	$ 227	$ 208
GI/SRI	274	265
Total	**$ 501**	**$ 473**

Other Information on Foreclosed Property:

Additional information on FHA foreclosed property as of September 30, 2006 and 2005 is as follows:

	2006	2005
Number of property in foreclosure process	120	30
Number of property held	37,569	26,751
Average holding period for property held	6 months	6 months

Pre-Credit Reform Valuation Methodology

A separate analysis was conducted to adjust the loan loss estimate for anticipated reductions in project-based Section 8 rental assistance subsidies administered by the Office of Affordable Housing Preservation (OAHP) since it is attributable to approximately 98 percent of the total LLR. All projects that are required to submit financial statements and have submitted annual financial statements within the past two years, received Section 8 assistance, expected to expire in the next five years, and had contract rents exceeding 100 percent of fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the contract rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and the projects were grouped into the following three categories:

<u>No action:</u> Projects that could continue to pay their operating expenses and mortgage payment.

<u>Partial claim:</u> Projects that could pay their operating expenses but could not make a full mortgage payment.

<u>Full Claim:</u> Projects that could no longer meet their mortgage payment and operating expenses.

Based on this analysis, appropriate adjustments were made to each project's loan loss estimate. No changes were made for projects requiring no action. For those classified as a partial claim, a new sustainable mortgage amount was calculated. The loss estimated on loans classified as partial claims was based on the amount of the claim payment. For loans classified as full claim, the loss estimate was set to 100 percent of the project's unpaid principal balance.

Credit Reform Valuation Methodology

For post-1991 cohorts FHA values its Credit Reform Liability for Loan Guarantee (LLG) and related assets (notes and properties) in inventory at the net present value of their estimated future cash flows. The disbursement weighted interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loan term is the discount factor used in the present value calculation for cohorts 1992 to 2000. For the 2001 and future cohorts, the rate on U.S. Treasury securities of maturity comparable to the term of each cash flow for the loan guarantee is used in the present value calculation. This methodology is referred to as the basket of zeros discounting methodology. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-11, Part 4, "Instructions on Budget

Execution." The basket of zeros discount factors are also disbursement weighted.

To apply the present value computations, FHA divides the loans into cohorts. Individual cohorts are defined by year of insurance activity and program type. Multifamily cohorts are defined based on the year in which loan guarantee commitments are made. Single Family mortgages are grouped into cohorts based on loan endorsement dates for both the MMI and the GI/SRI funds. Within each cohort year, loans are subdivided by risk categories. Each risk category has characteristics that distinguish it from others, including risk profile, premium structure, and the type and quality of collateral underlying the loan.

The cash flow estimates that underlie the present value calculations are determined using the significant assumptions detailed below.

Significant Assumptions – FHA developed financial models in order to estimate the present value of future program cash flows. The models incorporate information on the cash flows' expected magnitude and timing. The models rely heavily on the following loan performance assumptions:

- <u>Conditional Termination Rates:</u> The estimated probability of an insurance policy claim or non-claim termination in each year of the loan guarantee's term.

- <u>Recovery Rates:</u> The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.

- <u>Claim Amount:</u> The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

<u>Sources of data</u>: FHA developed assumptions for claim rates, prepayment rates, claim amounts, and recoveries based on historical data obtained from its systems.

<u>Economic assumptions</u>: Forecasts of economic conditions used in conjunction with loan-level data to generate Single Family and Multifamily claim and prepayment rates were obtained from Global Insight (formerly DRI) forecasts of U.S. annual economic figures. The liability for loan guarantee estimate is likely to change depending on the time at which the economic forecasts are collected. OMB provides other economic assumptions used, such as discount rates.
<u>Reliance on historical performance</u>: FHA relies on the average historical performance of its insured portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all influence loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years for Multifamily programs and affect loan performance accordingly.

<u>Current legislation and regulatory structure</u>: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

Because of uncertainties inherent in the loan performance assumptions underlying the LLG and related receivables on notes and properties in inventory, actual cash flows will vary from the estimates over time. A reestimate process each year allows for estimates to be adjusted.

Discussion of Change in the Liability for Loan Guarantees

FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time, FHA's credit subsidy rates have varied. The variance is caused by three factors: (1)

additional loan performance data underlying the credit subsidy rate estimates, (2) revisions to the calculation methodology used to estimate the credit subsidy rates, and (3) revisions on expected claims and prepayments derived from the most recent Actuarial Review of the MMI Fund. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for the 2006 cohort in fiscal year 2004. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be compared to the credit subsidy rates estimated at the end of 2006. The two rates can be reconciled through credit subsidy reestimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2006 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidies reestimate. Overall, FHA's liability decreased by $1.1 billion from the fiscal year 2005 estimates.

Mutual Mortgage Insurance (MMI) - The MMI fund provides insurance for private lenders against losses on single family mortgages. The fund protects lenders against loan default on mortgages for properties that meet certain minimum requirements. This allows lenders to provide credit to borrowers who might not meet conventional underwriting requirements.

Due to the magnitude of the MMI fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2006, FHA continued to experience higher overall claim rates from the increasing insurance of loans with down payment assistance. The majority of this change is due to the revised assumption on anticipated loss rates on foreclosed properties. Loss rates have increased as proceeds received from the sale of foreclosed properties have declined. The decline is largely associated with loans where borrowers received down payment assistance from seller-financed nonprofits. A recent Internal Revenue Service ruling has withdrawn nonprofit status from such nonprofits, and the incidence of such loans is expected to decline over the next couple of years. However, loss rates may continue to be elevated as already endorsed loans experience claim and conveyance, reducing anticipated cash flows from recoveries in future years and hence increasing the overall liability.

GI/SRI Home Equity Conversion Mortgage (HECM) - The FHA insured reverse mortgage (HECM) is used by senior homeowners age 62 and older to convert the equity in their home into monthly streams of income and/or a line of credit to be repaid when they no longer occupy the home. Unlike ordinary home equity loans, a HUD reverse mortgage does not require repayment as long as the home is the borrower's principal residence. Based on the projected cash flows for all active insurance in force, FHA estimates a liability of $123 million for the HECM program.

Since the inception of the program, FHA has insured 237,586 HECM loans with a maximum claim amount of $44 billion. Of these 237,586 HECM loans insured by FHA, 177,485 loans with a maximum claim amount of $36 billion are still active. As of end of fiscal year 2006 the insurance in force of these active loans was $18 billion. The insurance in force for FHA is the outstanding balance on the active loans. The insurance in force includes balance drawn by the mortgagee; interest accrued on the balance drawn, service charges, and mortgage insurance premium. The maximum claim amount is the dollar ceiling to which the outstanding loan balance can grow before being assigned to FHA. Even though the HECM volume increased significantly during fiscal year 2006, the HECM liability only increased from $111 million in fiscal year 2005 to $123 million in fiscal year 2006.

GI/SRI Section 221(d)(4) - The Section 221(d)(4) program was established to provide mortgage insurance for the construction or substantial rehabilitation of Multifamily rental properties with five or more units. Under this program, HUD may insure up to 90 percent of the total project cost and is prohibited from insuring loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest Multifamily program in the GI/SRI fund. The Section 221(d)(4) liability decreased in fiscal year 2006 and was impacted by two major changes.

First, since 1991, FHA has realized a decrease in the length of time assets are held in inventory after assignment and acquisition. In fiscal year 2006, FHA reduced the holding period assumption for assets recovered via property disposition, which resulted in a decrease to the 221(d)(4) liability estimate.

Second, FHA excluded the assumption used to capture administrative expenses at time of claim. In fiscal year 2006, 1.5% of the claim amount was excluded from the cost estimate of the 221(d)(4) program. The administrative expense is a cost of the program account rather than the financing account and should not be included as a cash outflow. This resulted in a decrease to the 221(d)(4) liability estimate.

Mark to Market – The Mark to Market (MTM) program was established by legislation to assess rents at the time of Section 8 Assistance contract renewal. If rents are above market levels, the project is referred to OAHP. OAHP then evaluates the project for potential financial restructuring to determine if the project could survive given the lower revenues from reduced rents. The MTM liability decreased in fiscal year 2006 as a result of five major changes to estimation procedures. These changes were necessary to improve the MTM estimations to more closely approximate MTM actual program activity.

- The MTM program was initially implemented for projects with 20-year Section 8 contracts, therefore only loans that originated in the pre-Credit Reform liquidating account would be eligible for MTM restructuring. Post-Credit Reform financing account loans are only eligible for MTM restructuring if they originated in the liquidating account and refinanced into the financing account. As a result, only loans pursuant to Sections of the Act (SOA) assigned to the 223(a)(7) and 223(f) refinancing risk categories are analyzed to determine MTM eligibility. By limiting the eligible universe to these two risk categories, the financing account MTM liability estimate is more in representative of actual MTM program activity.

- Historical data shows that the majority of the MTM restructurings occurred for projects with rents greater than or equal to 100% of fair market rent. As a result, projects with rents below market levels were excluded from the MTM analysis.

- Projects that are not required to submit an annual financial statement and those projects that failed to submit a financial statement within the past two years were determined to be ineligible for MTM restructuring.

- Loans endorsed prior to fiscal year 2005 and subject to prepayment lockout restrictions are excluded from the MTM analysis. A mortgagee letter sent out by the Commissioner on October 12, 2004 waives the 5-year prepayment lockout restriction for loans that will go through the MTM restructuring process. As a result, FHA excludes loans in the 223(a)(7) and 223(f) risk categories that originated prior to the release of the letter. Loans that originated subsequent to the memo are not subject to the prepayment lockout and are eligible for the MTM program.

- Lastly, the projected time horizon for projects eligible for the MTM program was reduced from 10 years to 5 years. Five years is more appropriate for the remaining OAHP pipeline.

GI/SRI Section 234(c) - The Section 234(c) program insures a loan for as many as 30 years to purchase a unit in a condominium building. One of the many purposes of FHA's mortgage insurance programs is to encourage lenders to make affordable mortgage credit available for non-conventional forms of ownership. Condominium ownership, in which the separate owners of the individual units jointly own the development's common areas and facilities, is one particularly popular alternative. The Section 234(c) program is FHA's largest Single Family program in the GI/SRI fund. Historically, the program generates a reduction in credit subsidy expense. As in the MMI fund the projected losses from future foreclosures were significantly increased to factor the decrease in proceeds and the additional losses from down payment assistance loans. This has resulted in an increase in the total liability. Though the liability is still negative it has become less negative after the effect of this increase in projected losses from future foreclosures.

GI/SRI Section 203(k) - The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a mortgage loan insured by FHA. Though the down payment assistance loans do not have a major impact on loss rates the decrease in proceeds from sales of foreclosed properties has significantly increase the anticipated losses. To address this increase in loss rates FHA this year used fiscal year 2006 year's (one year) actual loss rate instead of an average loss rate of last three years. This change in assumption calculation resulted in a higher projected loss rates for future years resulting in a higher liability.

Additionally, in the past, this program encountered incidents of fraud and FHA explicitly accounts for these risks through its LLG estimates. Based on management's judgment on claim costs and the additional rehabilitation costs an $81 million liability is included in the LLG associated with these fraud cases.

Hurricane Cost Estimate

At the end of fiscal year 2005 the damage assessments for hurricane Katrina were not complete and there was not sufficient information for FHA to reasonably estimate the losses or predict the liability. This was subsequently addressed during the preparation of the fiscal year 2007 budget, at which time OMB included additional liability estimates for hurricane Katrina. These additional amounts were apportioned by OMB and recorded by FHA during fiscal year 2006. This adjustment resulted in an additional $250 million added to the GI/SRI reestimate and an additional $1.1 billion added to the MMI/CMHI reestimate, which was combined with current year cost estimates for the MMI and GI/SRI funds to provide for the total liability to the LLG and LLR of $3.5 billion.

Single Family Hurricane Cost

FHA evaluated all open default cases from the hurricane-impacted areas as of July 31, 2006. The various status categories found for these default cases and the methodology used to estimate claims and cost for each category are described below.

- Loans in foreclosure processing: All cases currently in foreclosure processing or pre-foreclosure sale attempts were taken to full claim in this analysis.

- Loans awaiting help from state, local and or other sources: Cases awaiting help were assigned to partial claim solutions depending on the property location state. Loans in Louisiana and Mississippi are given a 60% chance of getting assistance as Louisiana and Mississippi are still processing requests for assistance. In other states, the probability of assistance assumed is 25%. These probabilities are judgments made by the program office. For cases receiving assistance, HUD used failure rate of loss mitigation actions from actual experience in the national portfolio.

- Loans of borrowers that have not reported to their loan servicers and have delinquency periods exceeding 5 months: All such cases were assigned to full claim status in fiscal year 2007 and fiscal year 2008.

- Loans in workouts: For cases where servicers are actively working with borrowers to affect a reinstatement cure (special forbearance, repayment plan, mortgage modification, or partial claim) HUD assigned success and failure rates based on historical experience in the national portfolio.

- Other open default cases: The final group of hurricane impacted cases includes delinquencies less than or equal to 5 months where there is no defined lender actions. These are considered non-disaster related and are distributed to resolutions according to normal expectations- 35% workouts, 35% cures, and 30% foreclosures.

- Failures of loss mitigation actions: A claim must occur by the end of fiscal year 2008 for there to be a "failure" counted as hurricane cost. All claims are distributed in fiscal year 2007 and fiscal year 2008 according to historical average times for failed loss mitigation actions that result in full claims.

Based on the above methodology, HUD estimated 11,468 total claims (including failed loss mitigation actions) with unpaid principal balance of $902.6 million. HUD program offices estimated a 62% loss rate for these properties, which is higher than the normal loss rate of 36% in the national portfolio. The 62% loss rate was taken from the pool of not-for-profit sales in the MMI fund in fiscal year 2006.Based on the above methodology and assumptions the estimated net present value hurricane cost is $623.26 million.

Multifamily Hurricane Cost
Impacted properties included in the multifamily hurricane cost estimate were determined from physical inspections conducted by FHA’s Office of Multifamily Housing Programs. Damage assessments were rated on a scale of 1-9. A damage assessment of 1 related to a power outage with no dislocation of tenants. A damage assessment of 9 related to severe damage with demolition of the property possible. If a property had a damage assessment of 7 or greater, the possibility of default was determined to be high and these properties were included in the hurricane cost estimate. Impacted properties were identified and claims are anticipated to occur in fiscal years 2007 and 2008. For multifamily properties, a liability was estimated on those properties impacted by Hurricane Katrina. The claim amount is assumed a complete write-off with zero recoveries and zero premiums collected. The Multifamily hurricane cost is estimated to be $63.2 million. Impacts from Hurricanes Rita and Wilma were immaterial and no cost was estimated related to these hurricanes.

Note 7. Other Assets

The following table presents the composition of other assets held by FHA as of September 30:

(Dollars in millions)

		2006		2005
Intragovernmental:				
Advances to HUD for Working Capital Fund Expenses	$	24	$	54
Total	**$**	**24**	**$**	**54**
With the Public:				
Escrow Monies Deposited at Minority-Owned Banks	$	110	$	95
Undistributed Charges		30		2
Total	$	**140**	$	**97**

Advances to HUD for Working Capital Fund Expenses

The Working Capital Fund was established by HUD to consolidate, at the department level, the acquisition of certain property and equipment to be used by different organizations within HUD. Advances to HUD for Working Capital Fund expenses represent the amount of payments made by FHA to reimburse the HUD Working Capital Fund for its share of the fund's expenses prior to the receipt of goods or services from this fund.

Escrow Monies Deposited at Minority-Owned Banks

FHA holds in trust escrow monies received from the borrowers of its Multifamily mortgage notes to cover property repairs and renovations expenses. These escrow monies are deposited at the U.S. Treasury (see Note 2), invested in U.S. Treasury securities (see Note 4 - GI/SRI Investments) or deposited at minority-owned banks.

Undistributed Charges

Undistributed charges include FHA disbursements processed by the U.S. Treasury but the identification of the specific FHA operating area associated with the disbursement has not been determined by the end of the reporting period. When the FHA operating area that initiated the disbursement is identified, the undistributed charges are reclassified by recognizing new expenses or by liquidating previously established accounts payable.

Note 8. Accounts Payable

Accounts payable as of September 30 are as follows:

(Dollars in millions)

		2006		2005
With the Public:				
Claims Payable	$	206	$	281
Premium Refunds and Distributive Shares Payable		84		112
Disbursements in Transit		46		41
Miscellaneous Payables		60		163
Total	$	**396**	$	**597**

Claims Payable

Claims payable represents the amount of claims that have been processed by FHA, but the disbursement of payment to lenders has not taken place at the end of the reporting period.

Premium Refunds and Distributive Shares Payable

Premium refunds payable are refunds of previously collected Single Family premiums that will be returned to the borrowers resulting from prepayment of the insured mortgages. Distributive shares payable represent the amount of excess revenues in the liquidating account of the CMHI fund that is to be distributed to the mortgagors at the discretion of the Secretary of HUD.

Disbursements in Transit

Disbursements in transit represent the payments recorded in FHA financial systems that have not been processed by the U.S. Treasury. The disbursements in transit will be reclassified into the reductions of the Fund Balance with U.S. Treasury once the disbursements are confirmed as paid by the U.S. Treasury.

Miscellaneous Payables

Miscellaneous payables include interest enhancement payables, interest penalty payables for late payment of claims, generic debt payables and other payables related to various operating areas within FHA.

Note 9. Debt

The following tables describe the composition of debt held by FHA as of September 30, 2006:

(Dollars in millions)	2005			2006	
	Beginning Balance	**Net Borrowing**	**Ending Balance**	**Net Borrowing**	**Ending Balance**
Agency Debt:					
Debentures Issued to Claimants	$ 187	$ (55)	$ 132	$ (37)	$ 95
Other Debt:					
Borrowings from U.S. Treasury	7,635	(87)	7,548	(1,290)	6,258
Total	**$ 7,822**	**$ (142)**	**$ 7,680**	**$ (1,327)**	**$ 6,353**

	2006	**2005**
Classification of Debt:		
Intragovernmental Debt	$ 6,258	$ 7,548
Debt held by the Public	95	132
Total	**$ 6,353**	**$ 7,680**

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4 percent to 12.875 percent in both fiscal years 2006 and 2005. Lenders may redeem FHA debentures prior to maturity in order to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30 was $95 million in fiscal year 2006 and $129 million in fiscal year 2005. The fair values for fiscal years 2006 and 2005 were $143 and $181 million, respectively.

Borrowings from U.S. Treasury

In accordance with Credit Reform accounting, FHA borrows from the U.S. Treasury when cash is needed in its financing accounts. Usually, the need for cash arises when FHA has to transfer the negative credit subsidy amounts related to new loan disbursements, and existing loan modifications from the financing accounts to the general fund receipt account (for cases in GI/SRI funds) or to the liquidating account (for cases in MMI/CMHI funds). In some instances, borrowings are also needed to transfer the credit subsidy related to downward reestimates from the GI/SRI financing account to the GI/SRI receipt account or when available cash is less than claim payments due.

During fiscal year 2006, FHA's U.S. Treasury borrowings carried interest rates ranging from 2.41 percent to 7.36 percent. In fiscal year 2005 the carried interest rates ranged from 2.41 percent to 7.34 percent. Fiscal year 2006 maturity dates occur from September 2009 – September 2024. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 10. Other Liabilities

The following table describes the composition of other liabilities as of September 30, 2006 and 2005:

(Dollars in millions)	Current		Non-Current		Total	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
Intragovernmental:						
Special Receipt Account Liability	$ 2,486	$ 772	$ -	$ -	$ 2,486	$ 772
Total	**$ 2,486**	**$ 772**	**$ -**	**$ -**	**$ 2,486**	**$ 772**
With the Public:						
Trust and Deposit Liabilities	$ 170	$ 170	$ -	$ -	$ 170	$ 170
Unearned Premiums	21	27	120	(50)	141	-23
Undistributed Credits	50	58	-	-	50	58
Miscellaneous Liabilities	216	168	-	-	216	168
Total	**$ 457**	**$ 423**	**$ 120**	**$ (50)**	**$ 577**	**$ 373**

Special Receipt Account Liability

The special receipt account liability is created from negative subsidy endorsements and downward credit subsidy reestimates in the GI/SRI special receipt account.

Trust and Deposit Liabilities

Trust and deposit liabilities include mainly escrow monies received by FHA for the borrowers of its mortgage notes and earnest money received from potential purchasers of the FHA foreclosed properties. The escrow monies are eventually disbursed to pay for insurance, property taxes, and maintenance expenses on behalf of the borrowers. The earnest money becomes part of the sale proceeds or is returned to any unsuccessful bidders.

Unearned Premiums

As discussed in Note 1, unearned premiums represent premiums collected for the pre-1992 loan guarantees, but not recognized as revenue because the earning process has not been completed.

Undistributed Credits

Undistributed credits represent FHA collections processed by U.S. Treasury, but the identification of the specific operating area associated with the collections has not been determined at the end of the reporting period. When the FHA operating area that is entitled to the collections is identified, the undistributed credits are reclassified by recognizing revenue or by liquidating previously established accounts receivable.

Miscellaneous Liabilities

Miscellaneous liabilities include other unearned revenue from Single Family and Multifamily operations. It also includes loss contingencies that are recognized by FHA for past events that warrant a probable, or likely, future outflow of measurable economic resources.

Note 11. Commitments and Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of one of these legal actions and claims will have a material affect on FHA's consolidated financial statements as of, and for, the period ending September 30, 2006. FHA has recognized an estimated amount of $24 million as a contingent liability due to the probable, or likely, adverse judgment in this case. Additionally, there is one case where judgment against FHA is considered reasonably possible with a potential loss estimated at $18 million.

Pending or Threatened Litigation Against FHA

(Dollars in millions)

Expected Outcome		Estimated Loss	Number of Cases
Probable	$	24	1
Reasonably Possible	$	18	1
Remote	$	-	5

Note 12. Gross Costs

Gross costs incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)		2006			2005	
		MMI/CMHI	GI/SRI		MMI/CMHI	GI/SRI
Intragovernmental:						
Interest Expense	$	342	101	$	373	94
Imputed Cost		10	13		10	13
Other Expenses		35	33		22	20
Total	**$**	**387**	**147**	**$**	**405**	**127**
With the Public:						
Salary and Administrative Expense	$	192	241	$	186	245
Subsidy Expense		642	(1,601)		889	(271)
Interest Expense		284	(248)		178	14
Bad Debt Expense		20	(24)		(37)	(163)
Loan Loss Reserve		(3)	(734)		(32)	(1,106)
Other Expenses		-	317		59	292
Total	**$**	**1,135**	**(2,049)**	**$**	**1,243**	**(989)**

Interest Expense

Intragovernmental interest expense includes interest expense on borrowings from the U.S. Treasury in the financing account. Interest expense is calculated annually for each cohort using the interest rates provided by the U.S Treasury. Interest expense with the public consists of interest expense on debentures issued to claimants to settle claim payments and interest expense on the annual credit subsidy reestimates.

Imputed Costs/Imputed Financing

Imputed costs represent FHA's share of the departmental imputed cost calculated and allocated to FHA by the HUD CFO office. Federal agencies are required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, to account for costs assumed by other Federal organizations on their behalf. The HUD CFO receives its imputed cost data from the Office of Personnel Management (OPM) for pension costs, federal employee health benefits (FEHB) and life insurance costs. It also receives Federal Employees' Compensation Act (FECA) costs from the Department of Labor (DOL). Subsequently, using its internally developed allocation basis, HUD CFO allocates the imputed cost data to each of its reporting offices. The imputed costs reported by FHA in its Statements of Net Cost are equal to the amounts of imputed financing in its Statements of Changes in Net Position.

Salary and Administrative Expenses

Salary and administrative expenses include FHA's reimbursement to HUD for FHA personnel costs and FHA's payments to third party contractors for administrative contract expenses.

Subsidy Expense

Subsidy expense, positive and negative, consists of credit subsidy expense from new endorsements, modifications, and annual credit subsidy reestimates and the subsidy expense incurred by the Church Arson program. Credit subsidy expense is the estimated long-term cost to the U.S. Government of a direct loan or loan guarantee, calculated on a net present value basis of the estimated future cash flows associated with the direct loan or loan guarantee. Subsidy expense incurred by the Church Arson program is the expense of a HUD program administered by the Office of Community Planning and Development (CPD) even though its cost is funded through a FHA program account.

Bad Debt Expense

Bad debt expense represents the provision for loss recorded for uncollectible amounts related to FHA's pre-1992 accounts receivable and credit program assets. FHA calculates its bad debt expense based on the estimated change of these assets' historical loss experience and FHA management's judgment concerning current economic factors.

Loan Loss Reserve Expense

Loan loss reserve expense is recorded to account for the change in the balance of the loan loss reserve liabilities associated with FHA's pre-1992 loan guarantees. The loan loss reserve is provided for the estimated losses incurred by FHA to pay claims on its pre-1992 insured mortgages when defaults have taken place but the claims have not yet been filed with FHA.

Other Expenses

Other expenses with the public include only those associated with the FHA pre-1992 loan guarantees. They consist of net losses or gains on sales of FHA credit program assets, insurance claim expenses, fee expenses, and other miscellaneous expenses incurred to carry out FHA operations. Other intragovernmental expenses include FHA's share of HUD expenses incurred in the Working Capital Fund and expenses from intra-agency agreements. Additionally, future funded expenses result from the recognition of contingent liabilities recorded by FHA for past events that warrant a probable, or likely, future outflow of measurable economic resources.

Note 13. Earned Revenue

Earned revenues generated by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)		2006				2005		
		MMI/CMHI		GI/SRI		MMI/CMHI		GI/SRI
Intragovernmental:								
Interest Revenue from Deposits at U.S. Treasury	$	293	$	188	$	265	$	147
Interest Revenue from MMI/CMHI Investments		1,041		-		1,079		-
Total	**$**	**1,334**	**$**	**188**	**$**	**1,344**	**$**	**147**
With the Public:								
Premium Revenue	$	86	$	36	$	40	$	56
Interest Revenue		-		49		-		76
Other Revenue		8		-		1		190
Total	**$**	**94**	**$**	**85**	**$**	**41**	**$**	**322**

Interest Revenue

Intragovernmental interest revenue includes interest revenue from deposits at the U.S. Treasury and investments in U.S. Treasury securities. FHA's U.S. Treasury deposits are generated from post-1991 loan guarantees and direct loans in the financing accounts. FHA's investments in U.S. Treasury securities consist of investments of surplus resources in the MMI/CMHI liquidating accounts and of escrow monies collected from borrowers in the GI/SRI liquidating accounts.

Interest revenue with the public is generated mainly from FHA's acquisition of pre-1992 performing MNA notes from payments to lenders for defaulted guaranteed loans. Interest revenue associated with the post-1991 MNA notes is included in the Allowance for Subsidy balance.

Premium Revenue

According to the FCRA accounting, FHA's premium revenue includes only premiums associated with the pre-1992 loan guarantee business. Premium revenue for post-1991 loan guarantee cases is included in the balance of the LLG. The FHA premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July 1991, includes both up-front premiums and annual periodic premiums.

Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis.

The FHA up-front premium rates in fiscal year 2006 were:

	Premium Rate
Single Family	1.50%
Multifamily	0.50 %, 0.77%, or 0.80%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2006 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	0.25 %	0.50 %
Multifamily	0.50 %, 0.77%, or 0.80%	0.50 %, 0.77%, or 0.80%

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed in fiscal years 2005 and 2006, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

Other Revenue

Other revenue includes revenue associated with FHA pre-1992 loan guarantees. FHA's other revenue consists of late charges and penalty revenue, fee income, and miscellaneous income generated from FHA operations.

Note 14. Gross Cost and Earned Revenue by Budget Functional Classification

FHA cost and earned revenue reported on the Statements of Net Cost is categorized under the budget functional classification (BFC) for Mortgage Credit (371). All FHA U.S. Treasury account symbols found under the department code "86" for Department of Housing and Urban Development appear with the Mortgage Credit BFC.

Note 15. Transfers Out

Transfers out incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)

	U.S. Treasury	HUD	Total
Budgetary Financing Sources	$ 532	$ 234	$ 766
Other Financing Sources	1,692	-	1,692
FY 2006 Total	**$ 2,224**	**$ 234**	**$ 2,458**
Budgetary Financing Sources	$ 481	$ 233	$ 714
Other Financing Sources	297	-	297
FY 2005 Total	**$ 778**	**$ 233**	**$ 1,011**

Transfers Out to U.S. Treasury

Transfers out to U.S. Treasury consists of negative subsidy from new endorsements, modifications and downward credit subsidy reestimates in the GI/SRI general fund receipt account, and the prior year unobligated balance of budgetary resources in the GI/SRI liquidating account.

Transfers Out to HUD

Transfers out to HUD include a certain portion of FHA's monthly payments to HUD for salaries and expenses as well as amounts related to FHA's share in the departmental Working Capital Fund capitalized expense.

Note 16. Unexpended Appropriations

Unexpended appropriation balances at September 30, 2006 and 2005 are as follows:

(Dollars in millions)	Beginning Balance	Appropriations Received	Other Adjustments	Appropriations Used	Transfers-Out	Ending Balance
Positive Subsidy	$ 58	$ 9	$	$ (3)	$	$ 64
Administrative Expenses	450	728	(83)	(730)		365
Reestimates	-	361		(361)		
GI/SRI Liquidating	101	183		(84)	(35)	165
FY 2006 Total	**$ 609**	**$ 1,281**	**$ (83)**	**$ (1,178)**	**$ (35)**	**$ 594**
Positive Subsidy	$ 84	$ 10	$ (30)	$ (6)	$ -	$ 58
Administrative Expenses	458	748	(51)	(705)	-	450
Reestimates	-	767	-	(767)	-	-
GI/SRI Liquidating	157	462	-	(381)	(137)	101
FY 2005 Total	**$ 699**	**$ 1,987**	**$ (81)**	**$ (1,859)**	**$ (137)**	**$ 609**

As required under FCRA, FHA receives appropriations to cover expenses or fund shortages related to its loan guarantee and direct loan operations.

FHA receives appropriations in the annual program accounts for administrative and contract expenses. The GI/SRI no-year program account also receives appropriations for positive credit subsidy and upward reestimates. Additionally, FHA obtains permanent indefinite appropriations to cover any shortfalls for its GI/SRI pre-1992 loan guarantee operations.

When appropriations are first received, they are reported as unexpended appropriations. As these appropriations are expended, appropriations used are increased and unexpended appropriations are decreased. Additionally, unexpended appropriations are decreased when: the year-end unobligated balance in the GI/SRI liquidating account is returned to the U.S. Treasury; appropriations are rescinded; or other miscellaneous adjustments are required.

Note 17. Budgetary Resources

FHA has two program, two liquidating, and four financing appropriations. The Statement of Budgetary Resources has been prepared as a combined statement and as such, intra-entity transactions have not been eliminated.

Budget authority is the authorization provided by law to enter into obligations to carry out the guaranteed and direct loan programs and their associated administrative costs, which would result in immediate or future outlays of federal funds. FHA's budgetary resources include current budgetary authority (i.e., appropriations and borrowing authority) and unobligated balances brought forward from multi-year and no-year budget authority received in prior years, and recoveries of prior year obligations. Budgetary resources also include spending authority from offsetting collections credited to an appropriation or fund account. Obligated balances at the end of year consist of accounts payable, undelivered orders, and federal accounts receivable. Included in the undelivered orders balance, FHA has identified approximately $107 million of unliquidated contract balances that are being reviewed for contract close out and subsequent deobligation.

Unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not for new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligations or expenditure for any purpose.

FHA funds its programs through borrowings from the U.S. Treasury and debentures issued to the public. These borrowings and debentures are authorized through a permanent indefinite authority at interest rates set each year by the U.S. Treasury and the prevailing market rates.

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Permanently Not Available line item in the Statements of Budgetary Resources as of September 30, 2006 and year 2005 are $2,336 million and $1,526 million respectively. In fiscal year 2006, the $2,336 million amount is composed of a repayment of $82 million for debentures, anticipated repayment of $2,137 million for borrowing from the U.S. Treasury, a return to U.S. Treasury of $83 million for rescinded and cancelled appropriations, and a transfer to the U.S. Treasury of $35 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2005.

The SF-133 and the Statement of Budgetary Resources for fiscal year 2005 has been reconciled to the fiscal year 2005 actual amounts included in the P&F Schedules presented in the Budget of the United States Government. There were no significant reconciling items. Information from the fiscal year 2006 Statement of Budgetary Resources will be presented in the fiscal year 2008 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2008 and will be available from the Government Printing Office at that time.

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows for on September 30, 2006 and 2005:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Other Assets
U.S. Treasury	$ 10,568	$ 22,012	$ -
HUD	-	-	24
FY 2006 Total	**$ 10,568**	**$ 22,012**	**$ 24**
U.S. Treasury	$ 9,705	$ 22,745	$ -
HUD	-	-	54
FY 2005 Total	**$ 9,705**	**$ 22,745**	**$ 54**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2006 and 2005:

(Dollars in millions)

Agency	Borrowings from U.S. Treasury	Other Liabilities
U.S. Treasury	$	$
FY 2006 Total	**$** 6,258	**$** 2,486
U.S. Treasury	$	$
FY 2005 Total	**$** 7,548	**$** 772

Required Supplementary Information

Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program

(Dollars in millions)	MMI/CMHI		GI/SRI		Total	
	2006	2005	2006	2005	2006	2005
BUDGETARY RESOURCES						
Unobligated Balance Carried Forward						
Beginning of period	$ 26,746	$ 27,041	$ 2,747	$ 1,546	$ 29,493	$ 28,587
Recoveries of Prior Year Obligations	56	47	47	12	103	59
Budget Authority:						
Appropriations received	418	434	863	1,553	1,281	1,987
Borrowing Authority	536	403	361	763	897	1,166
Spending Authority from Offsetting Collections:						
Earned						
Collected	11,660	11,587	2,446	2,892	14,106	14,479
Receivable from Federal Sources	(62)	(119)	(39)	45	(101)	(74)
Unfilled Customer Orders	-	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-	-
Net Transfers	-	-	-	-	-	-
Permanently Not Available	(1,769)	(1,015)	(569)	(511)	(2,338)	(1,526)
TOTAL BUDGETARY RESOURCES	**$ 37,585**	**$ 38,378**	**$ 5,856**	**$ 6,300**	**$ 43,441**	**$ 44,678**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 11,218	$ 11,633	$ 2,800	$ 3,552	$ 14,018	$ 15,185
Unobligated Balance-Apportioned	1,082	2,222	1,211	504	2,293	2,726
Unobligated Balance Not Available	25,285	24,523	1,845	2,244	27,130	26,767
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 37,585**	**$ 38,378**	**$ 5,856**	**$ 6,300**	**$ 43,441**	**$ 44,678**
CHANGE IN OBLIGATED BALANCES						
Obligated Balance, Net, Beginning of Period:						
Unpaid Obligations Carried Forward	$ 1,442	$ 1,330	$ 888	$ 924	$ 2,330	$ 2,254
Receivable from Federal Sources Carried Forward	(262)	(381)	(52)	(6)	(314)	(387)
Obligations Incurred	11,218	11,633	2,800	3,552	14,018	15,185
Gross Outlays	(11,129)	(11,474)	(2,760)	(3,577)	(13,889)	(15,051)
Obligated Balance Transfers, Net:	-	-	-	-	-	-
Recoveries of Prior Year Obligations	(56)	(47)	(47)	(12)	(103)	(59)
Change in Receivable from Federal Sources	62	119	39	(45)	101	74
Obligated Balance, Net, End of Period:						
Unpaid Obligations	1,477	1,442	880	888	2,357	2,330
Receivable from Federal Sources	(203)	(262)	(11)	(51)	(214)	(313)
Outlays:						
Disbursements	11,129	11,474	2,760	3,577	13,889	15,051
Collections	(11,660)	(11,587)	(2,446)	(2,892)	(14,106)	(14,479)
Subtotal	(531)	(113)	314	685	(217)	572
Less: Offsetting Receipts	-	-	677	474	677	474
NET OUTLAYS	**$ (531)**	**$ (113)**	**$ (363)**	**$ 211**	**$ (894)**	**$ 98**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2006

(Dollars in millions)	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Unobligated Balance Carried Forward					
Beginning of period	$ 50	$ 38	$ 3,395	$ 23,263	$ 26,746
Recoveries of Prior Year Obligations	11	44	1	-	56
Budget Authority:					
Appropriations received	418	-	-	-	418
Borrowing Authority	-	-	536	-	536
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	48	9,450	2,162	11,660
Receivable from Federal Sources	-	-	-	(62)	(62)
Unfilled Customer Orders	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-
Net Transfers	3,404	-	-	(3,404)	-
Permanently Not Available	(22)	-	(1,747)	-	(1,769)
TOTAL BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 3,816	$ 84	$ 7,318	$ -	$ 11,218
Unobligated Balance-Apportioned	1	2	1,079	-	1,082
Unobligated Balance Not Available	44	44	3,238	21,959	25,285
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 3,861**	**$ 130**	**$ 11,635**	**$ 21,959**	**$ 37,585**
CHANGE IN OBLIGATED BALANCES					
Obligated Balance, Net, Beginning of Period:					
Unpaid Obligations Carried Forward	$ 94	$ 266	$ 1,082	$ -	$ 1,442
Receivable from Federal Sources Carried Forward	-	-	(2)	(260)	(262)
Obligations Incurred	3,816	84	7,318	-	11,218
Gross Outlays	(3,818)	(74)	(7,237)	-	(11,129)
Obligated Balance Transfers, Net:	-	-	-	-	-
Recoveries of Prior Year Obligations	(11)	(44)	(1)	-	(56)
Change in Receivable from Federal Sources	-	-	-	62	62
Obligated Balance, Net, End of Period:					
Unpaid Obligations	83	233	1,161	-	1,477
Receivable from Federal Sources	-	(1)	(1)	(201)	(203)
Outlays:					
Disbursements	3,818	74	7,237	-	11,129
Collections	-	(48)	(9,450)	(2,162)	(11,660)
Subtotal	3,818	26	(2,213)	(2,162)	(531)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 3,818**	**$ 26**	**$ (2,213)**	**$ (2,162)**	**$ (531)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2005

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Unobligated Balance Carried Forward					
Beginning of period	$ 49	$ 12	$ 3,461	$ 23,519	$ 27,041
Recoveries of Prior Year Obligations	8	2	37	-	47
Budget Authority:					
Appropriations received	434	-	-	-	434
Borrowing Authority	-	-	403	-	403
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	81	9,338	2,168	11,587
Receivable from Federal Sources	-	-	(132)	13	(119)
Unfilled Customer Orders	-	-	-	-	-
Anticipated for rest of year	-	-	-	-	-
Net Transfers	2,394	44	-	(2,438)	-
Permanently Not Available	(15)	-	(1,000)	-	(1,015)
TOTAL BUDGETARY RESOURCES	**$ 2,870**	**$ 139**	**$ 12,107**	**$ 23,262**	**$ 38,378**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 2,820	$ 101	$ 8,712	$ -	$ 11,633
Unobligated Balance-Apportioned	5	36	2,181	-	2,222
Unobligated Balance Not Available	45	2	1,214	23,262	24,523
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 2,870**	**$ 139**	**$ 12,107**	**$ 23,262**	**$ 38,378**
CHANGE IN OBLIGATED BALANCES					
Obligated Balance, Net, Beginning of Period:					
Unpaid Obligations Carried Forward	$ 81	$ 276	$ 973	$ -	$ 1,330
Receivable from Federal Sources Carried Forward	-	-	(133)	(248)	(381)
Obligations Incurred	2,820	101	8,712	-	11,633
Gross Outlays	(2,799)	(109)	(8,566)	-	(11,474)
Obligated Balance Transfers, Net:	-	-	-	-	-
Recoveries of Prior Year Obligations	(8)	(2)	(37)	-	(47)
Change in Receivable from Federal Sources	-		132	(13)	119
Obligated Balance, Net, End of Period:					
Unpaid Obligations	94	266	1,082	-	1,442
Receivable from Federal Sources	-	-	(2)	(260)	(262)
Outlays:					
Disbursements	2,799	109	8,566	-	11,474
Collections	-	(81)	(9,338)	(2,168)	(11,587)
Subtotal	2,799	28	(772)	(2,168)	(113)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 2,799**	**$ 28**	**$ (772)**	**$ (2,168)**	**$ (113)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2006

(Dollars in millions)	**86 0200**	**86x4072**	**86x4077 & 86x4105**	**GI/SRI Total**
BUDGETARY RESOURCES				
Unobligated Balance Carried Forward				
Beginning of period	$ 216	$ 35	$ 2,496	$ 2,747
Recoveries of Prior Year Obligations	14	28	5	47
Budget Authority:				
Appropriations received	680	183	-	863
Borrowing Authority	-	9	352	361
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	426	2,020	2,446
Receivable from Federal Sources	-	6	(45)	(39)
Unfilled Customer Orders	-	-	-	-
Anticipated for rest of year	-	-	-	-
Net Transfers	-	-	-	-
Permanently Not Available	(59)	(68)	(442)	(569)
TOTAL BUDGETARY RESOURCES	**$ 849**	**$ 619**	**$ 4,386**	**$ 5,856**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 668	$ 459	$ 1,673	$ 2,800
Unobligated Balance-Apportioned	22	138	1,051	1,211
Unobligated Balance Not Available	161	22	1,662	1,845
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 851**	**$ 619**	**$ 4,386**	**$ 5,856**
CHANGE IN OBLIGATED BALANCES				
Obligated Balance, Net, Beginning of Period:				
Unpaid Obligations Carried Forward	$ 99	$ 608	$ 181	$ 888
Receivable from Federal Sources Carried Forward	-	(1)	(51)	(52)
Obligations Incurred	668	459	1,673	2,800
Gross Outlays	(652)	(474)	(1,634)	(2,760)
Obligated Balance Transfers, Net:	-	-	-	-
Recoveries of Prior Year Obligations	(14)	(28)	(5)	(47)
Change in Receivable from Federal Sources	-	(6)	45	39
Obligated Balance, Net, End of Period:				
Unpaid Obligations	101	564	215	880
Receivable from Federal Sources	-	(6)	(5)	(11)
Outlays:				
Disbursements	652	474	1,634	2,760
Collections	-	(426)	(2,020)	(2,446)
Subtotal	652	48	(386)	314
Less: Offsetting Receipts	-	-	-	677
NET OUTLAYS	**$ 652**	**$ 48**	**$ (386)**	**$ (363)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2005

(Dollars in millions)	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Unobligated Balance Carried Forward				
Beginning of period	$ 261	$ 138	$ 1,147	$ 1,546
Recoveries of Prior Year Obligations	8	2	2	12
Budget Authority:				
Appropriations received	1,091	462	-	1,553
Borrowing Authority	-	(9)	772	763
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	507	2,385	2,892
Receivable from Federal Sources	-	-	45	45
Unfilled Customer Orders	-	-	-	-
Anticipated for rest of year	-	-	-	-
Net Transfers	-	-	-	-
Permanently Not Available	(66)	(231)	(214)	(511)
TOTAL BUDGETARY RESOURCES	**$ 1,294**	**$ 869**	**$ 4,137**	**$ 6,300**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 1,078	$ 834	$ 1,640	$ 3,552
Unobligated Balance-Apportioned	19	16	469	504
Unobligated Balance Not Available	197	19	2,028	2,244
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,294**	**$ 869**	**$ 4,137**	**$ 6,300**
CHANGE IN OBLIGATED BALANCES				
Obligated Balance, Net, Beginning of Period:				
Unpaid Obligations Carried Forward	$ 91	$ 543	$ 290	$ 924
Receivable from Federal Sources Carried Forward	-	(1)	(5)	(6)
Obligations Incurred	1,078	834	1,640	3,552
Gross Outlays	(1,060)	(768)	(1,749)	(3,577)
Obligated Balance Transfers, Net:	-	-	-	-
Recoveries of Prior Year Obligations	(8)	(2)	(2)	(12)
Change in Receivable from Federal Sources	-	-	(45)	(45)
Obligated Balance, Net, End of Period:				
Unpaid Obligations	99	608	181	888
Receivable from Federal Sources	-	(1)	(50)	(51)
Outlays:				
Disbursements	1,060	768	1,749	3,577
Collections	-	(507)	(2,385)	(2,892)
Subtotal	1,060	261	(636)	685
Less: Offsetting Receipts	-	-	-	474
NET OUTLAYS	**$ 1,060**	**$ 261**	**$ (636)**	**$ 211**

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Exhibit 1: SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

Recommendation Number	Ineligible 1/	Unsupported 2/	Unreasonable or Unnecessary 3/	Funds Put to Better Use 4/
1b				$107,176,596

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity where we cannot determine eligibility at the time of audit. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Unnecessary/Unreasonable costs are those costs not generally recognized as ordinary, prudent, relevant, and or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ Funds Put to Better Use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented resulting in reduced expenditures in subsequent period for the activities in question. Specifically, this includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.