
Required Supplementary Stewardship Information

Stewardship Expenses

In the Department of Education, discretionary spending constitutes approximately 58 percent of the budget and includes nearly all programs, the major exceptions being student loans and rehabilitative services. While spending for entitlement programs is usually a function of the authorizing statutes creating the programs and is not generally affected by appropriations laws, spending for discretionary programs is decided in the annual appropriations process. Most Department programs are discretionary.

Education in the United States is primarily a state and local responsibility. States, communities, and public and private organizations establish schools and colleges, develop curricula, and determine requirements for enrollment and graduation. The structure of education finance in America reflects this

predominantly state and local role. Of the estimated \$909 billion being spent nationwide on education at all levels for school year 2005–2006, about 90 percent comes from state, local, and private sources. The federal contribution to national education expenditures is about \$90.9 billion. The federal contribution includes education expenditures not only from the Department of Education, but also from other federal agencies such as the Department of Health and Human Services' Head Start Program and the Department of Agriculture's School Lunch Program.

The Department's \$99.8 billion appropriation is 11.0 percent of total education expenditures in the United States and 3.7 percent of the federal government's \$2.7 trillion budget in fiscal year 2006.

Investment in Human Capital

Office of Federal Student Aid. The Office of Federal Student Aid administers need-based financial assistance programs for students pursuing postsecondary education and makes available federal grants, direct loans, guaranteed loans, and work-study funding to eligible undergraduate and graduate students.

Office of Elementary and Secondary Education. The Office of Elementary and Secondary Education provides leadership, technical assistance, and financial support to state and local educational agencies for the maintenance and improvement of preschool, elementary, and secondary education. Financial assistance programs support services for children in high-poverty schools, institutions for neglected and delinquent children, homeless children, certain Indian children, children of migrant families, and children who live on or whose parents work on federal property. Funding is also provided to increase the academic achievement of students by ensuring that all teachers are highly qualified to teach.

Office of Special Education and Rehabilitative Services. The Office of Special Education and Rehabilitative Services supports state and local programs that assist in educating children, youth, and adults with special needs to increase their level of employment, productivity, independence, and integration into the community. Funding is also provided for research to improve the quality of their lives.

Office of Safe and Drug-Free Schools. The Office of Safe and Drug-Free Schools supports efforts to create safe and violence-free schools, respond to crises, prevent drug and alcohol abuse, ensure the health and well-being of students, and teach students good citizenship and character. Special character and civic education initiatives are funded to reach those in state and local correctional institutions. Grants emphasize coordinated, collaborative responses to develop and maintain safe, disciplined, and drug-free learning environments.

Office of Innovation and Improvement. The Office of Innovation and Improvement makes

strategic investments in educational practices through grants to states, schools, and community and nonprofit organizations. The office leads the movement for greater parental options such as charter schools. Further, the office supports special grants designed to raise student achievement by improving teachers' knowledge and understanding of and appreciation for traditional U.S. history.

Institute of Education Sciences. The Institute of Education Sciences compiles statistics; funds research, evaluations, and information dissemination; and provides research-based guidance to further evidence-based policy and practice focused on significant education problems. Research programs examine empirically the full range of issues facing children and individuals with disabilities, parents of children with disabilities, school personnel, and others. The National Library of Education is the largest federally funded library devoted entirely to education and provides reference and information services, collection and technical services, and resource sharing and cooperation.

Office of English Language Acquisition. The Office of English Language Acquisition directs programs designed to enable students with limited English proficiency to become proficient in English and meet state academic content and student achievement standards. Enhanced instructional opportunities are provided to children and youths of Native American, Alaska

Native, Native Hawaiian Pacific Islander, and immigrant backgrounds. Grants pay the federal share of the cost of model programs for the establishment, improvement, or expansion of foreign language study in elementary and secondary schools.

Office of Vocational and Adult Education. The Office of Vocational and Adult Education funds academic, vocational, and technical education for youth and adults in high schools, community colleges, and regional technical centers. Educational opportunities are provided for adults over the age of 16, not currently enrolled in school, who lack high school diplomas or the basic skills to function effectively as parents, workers, and citizens.

Office of Postsecondary Education. The Office of Postsecondary Education provides grants to colleges and universities to promote reform, innovation, and improvement in postsecondary education; increased access to and completion of postsecondary education by disadvantaged students; strengthening of the capacity of colleges and universities that serve a high percentage of minority and disadvantaged students; and teacher and student development resources. The international programs promote international education and foreign language studies and research. The office administers the accrediting agency recognition process and coordinates activities with states that affect institutional participation in federal financial assistance programs.

Program Inputs

The Department currently administers programs affecting every area and level of education. The Department's elementary and secondary programs annually serve 15,500 school districts and more than 52 million students attending over 88,000 public schools and more than 28,000 private schools. Department programs also provide grant, loan, and work-study assistance to more than 10 million postsecondary students.

While the Department's programs and responsibilities have grown substantially over the years, the Department itself has not. Since *No Child Left Behind* was enacted in 2001, the

Department's staff of approximately 4,111 is 10 percent below the 4,566 employees who administered federal education programs in 2001. At the same time, the Department manages 40 percent more in funds in 2006 than it did in 2001 when its human capital investment was only \$38.7 billion. These staff reductions, along with a wide range of management improvements, have helped limit administrative costs to less than 2 percent of the Department's budget, ensuring that the Department delivers about 98 cents on the dollar in education assistance to states, school districts, postsecondary institutions, and students.

Summary of Human Capital Expenses					
<u>(Dollars in Millions)</u>	2006	2005	2004	2003	2002
Federal Student Aid Expense					
Direct Loan Subsidy	\$ 6,655	\$ 5,211	\$ (543)	\$ 4,716	\$ 877
Guaranteed Loan Subsidy	28,062	9,863	8,516	2,509	3,988
Grant Programs	15,447	15,070	14,943	13,836	12,256
Salaries & Administrative	172	164	186	179	207
Subtotal	50,336	30,308	23,102	21,240	17,328
Other Departmental					
Elementary and Secondary Education	21,710	22,940	21,188	19,493	16,127
Special Education & Rehabilitative Services	15,215	13,995	12,687	11,529	9,906
Other Departmental Programs	5,353	6,067	5,160	4,828	4,531
Salaries & Administrative	467	486	448	395	472
Subtotal	42,745	43,488	39,483	36,245	31,036
Grand Total	\$93,081	\$73,796	\$62,585	\$57,485	\$48,364

During the early fall of 2005, just as schools were opening, hurricanes Katrina and Rita devastated the Gulf Coast. The Department's investment in the rebuilding of the educational systems of this region and the support provided to the districts affected across the country are reflected in the numbers above, representing almost 2 percent of the Department's 2006

budget. As a result, the Department has directly affected the lives of schoolchildren, their teachers, their schools, and the local economies of hundreds of communities throughout the United States. This investment, along with the investments made by other federal programs, represents one of the greatest educational efforts in the history of our country.

Program Outcomes

Education is the stepping-stone to higher living standards for American citizens. Education is vital to national economic growth. But education’s contribution is more than increased productivity and incomes. Education improves health, promotes social change, and opens doors to a better future for children and adults.

Economic outcomes, such as wage and salary levels, historically have been determined by the educational attainment of individuals and the skills employers expect of those entering the labor force.

Both individuals and society as a whole have placed increased emphasis on educational attainment as the workplace has become increasingly technological,

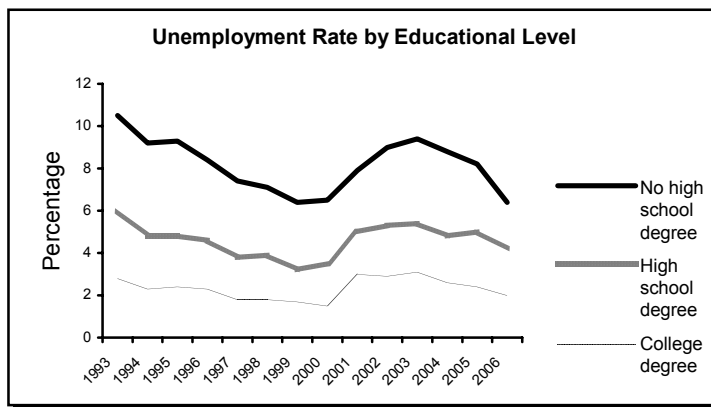
and employers now seek employees with the highest level of skills. For prospective employees, the focus on higher-level skills means investing in learning or developing skills through education. Like all investments, developing higher-level skills involves costs and benefits.

Returns, or benefits, of investing in education come in many forms. While some returns accrue for the individual, others benefit society and the nation in general. Returns related to the individual include higher earnings, better job opportunities, and jobs that are less sensitive to general economic conditions. Returns related to the economy and society include reduced reliance on welfare subsidies, increased participation in civic activities, and greater productivity.

Over time, the returns of developing skills through education have become evident. Statistics illustrate the rewards of completing high school and investing in postsecondary education.

Unemployment rate. Persons with lower levels of educational attainment were more likely to be unemployed than those who had higher levels of educational attainment. The September 2006 unemployment rate for adults (25 years old and over) who had not completed high school was 6.4 percent compared with 4.2 percent of those

with four years of high school and 2.0 percent for those with a bachelor’s degree or higher. Younger people with only high school diplomas tended to have higher unemployment rates than persons 25 and over with similar levels of education.



Annual Income. As of September 2006,

the annualized median income for adults (25 years and over) varied considerably by education level. Men with a high school diploma earned \$36,088, compared with \$61,932 for men with a college degree. Women with a high school diploma earned \$26,052, compared with \$47,840 for women with a college degree. Men and women with college degrees earned 73.8 percent more than men and women with high school diplomas. Earnings for workers with college degrees have increased in the past year by 10.5 percent for women and 6.6 percent for men. These returns of investing in education directly translate into the advancement of the American economy as a whole.

Report of the Independent Auditors



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 15 2006

Honorable Margaret Spellings
Secretary of Education
Washington, D.C. 20202

Dear Madam Secretary:

The enclosed reports present the results of the annual audits of the U.S. Department of Education's financial statements for fiscal years 2006 and 2005, to comply with the Government Management Reform Act of 1994 (GMRA). The reports should be read in conjunction with the Department's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of the Department as of September 30, 2006 and 2005, and for the years then ended. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; OMB's bulletin, *Audit Requirements for Federal Financial Statements*; and the GAO/PCIE *Financial Audit Manual*.

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the Department's financial statements, or conclusions about the effectiveness of internal control, whether the Department's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Sincerely,

A handwritten signature in black ink, appearing to read "John P. Higgins, Jr.", written over a light blue horizontal line.

John P. Higgins, Jr.

Enclosures

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Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.



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Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the U.S. Department of Education (the Department) 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 for the fiscal years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; 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*. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Department's internal control over financial reporting. Our audit included 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 the Department'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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management's Discussion and Analysis, required supplementary stewardship information, required supplementary information, and other accompanying information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. The other accompanying information has not been subjected to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no

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Report of Independent Auditors

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opinion on it. For the remaining information, 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.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 7, 2006, on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

A handwritten signature in black ink that reads 'Ernst + Young LLP'.

November 7, 2006



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Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2006, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 7, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States; 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*.

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether internal control had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 06-03 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures reported in the Management's Discussion and Analysis of the Department's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating 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.

However, as a result of the procedures we did perform, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described below.

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**Report on Internal Control**

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A material weakness, based on auditing standards generally accepted in the United States as established by the American Institute of Certified Public Accountants, is a reportable condition 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 caused by errors or fraud 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described below is a material weakness.

REPORTABLE CONDITIONS**1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)**

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, particularly during fiscal year (FY) 2006, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined to ensure that appropriate estimates are prepared.

During FY 2006, we noted that the Department made significant progress on certain aspects of this reportable condition. For example, the Department has developed a methodology to analyze student loan activity at the origination cohort level. In developing this cohort analysis system, a review of all transactions since 1992 was undertaken to allocate activity to the appropriate cohort. Together with this cohort analysis effort, the Department has also developed a set of credit program analytical reports. These reports have been developed to analyze the accounting activity and fluctuation analysis of the credit reform transactions. This process, which was put in place in FY 2006, has already been helpful to the Department in analyzing the potential sources of anomalous balances for further research. The newly instituted cohort level analytic tools and comparison of general ledger activity to model cash flows are significant steps in enhancing the Department's knowledge.



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Report on Internal Control

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In addition, the Credit Reform Workgroup (CRW), which was created in FY 2004 and consists of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service, met on a consistent basis and were heavily involved throughout the credit reform process in FY 2006. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to credit reform, and to manage the development of improved processes, procedures, and sources of information to enhance the credit reform estimation process.

However, after identifying the key improvements made or currently being made by the Department during our testing of loan guarantees, allowance for subsidy, and subsidy cost estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the direct loan (DL) receivable and liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM for the prior year also produces a forecast of the expected cash flows in the current year for the outstanding loans. The new data analysis tools prepared by the Department support more disaggregated reviews of data by cohort. The Department's efforts in this regard are evolving, particularly in capturing the value of the new data analysis tool. These efforts have highlighted differences between recorded activity by cohort in the Department's records as compared to expected cash flows or cash flows derived from credit systems which merit further investigation.
- The early phase of the loan estimation process includes the development of the assumptions which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. We continue to advocate completion of this process.

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- Particularly in areas that have relatively less predictive capability in the existing model, management should consider the use of reasonable simplified assumptions in estimate development, which can result in simpler programs, thus establishing transparency and limiting the potential for errors. The pattern of large re-estimates in the Department's programs, which reflect difficulties projecting future cash flows, can lead to a call for model enhancements which generate successively more complex and theoretically precise estimates. On balance, however, such refinement may do little to counteract the volatility of the estimates which are highly sensitive to changes in the underlying data. Introducing further complexity may create the appearance of further precision which is largely unwarranted due to the underlying volatility. Such changes, by further complicating the model and the process to develop the estimate, can also significantly increase the risk of errors in updating and running the model.
- FFEL program receivables are classified as pre-1992 loans (liquidating account loans) and post-1991 loans (financing account loans). The Department records certain collections on each of these loan categories using an estimation process (splitter process), as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to Treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the pre-1992 loans. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. As noted earlier, some improvements have been achieved with the development of certain aspects of cohort level analysis. Accurate cohort-level data is increasingly important to ensure that estimates in the subsidy models are appropriately adjusted as cohorts from the early 1990s wind down, and cash flows from default activities create temporary demands for cash that are currently funded on an aggregate basis across cohorts. The process may ultimately help resolve the splitter issues discussed above.
- The Department continues to be challenged in estimating lender and borrower behavior, and relies significantly on prior patterns to estimate future activity. There may be situations, however, in which a refinement of such estimates should be made if circumstances suggest that the pattern will not repeat. Due to lags in the receipt of information on consolidation loans, the Department did not accurately estimate the split between in-school and out-of-school borrowers who consolidated in developing FY 2005 subsidy rates. When actual figures were known, it was determined that the Department had underestimated in-school consolidations, resulting in a re-estimate during FY 2006. Interest rates for in-school borrowers were much lower than for borrowers who were out of school, resulting in an increased subsidy for FY 2006.

While patterns in the SLM reflect historical data, it seems possible that the level of consolidations will decrease significantly in the future, since many of the incentives for borrowers to consolidate, such as locking in lower interest rates in a rising interest rate environment, are no longer available. High consolidation volume has potentially



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artificially masked long term loan defaults and potential write-offs, since the consolidation process pays off the old loan and establishes a new loan. While the Department's approach is data based, users of the estimates should be made aware of the significant volatility of the estimates and potential for significant future re-estimates as the program changes take effect, the interest rate environment changes and actual default losses become more readily determined.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
2. Document, in detail, the programs written to develop the assumptions for the SLM and document scenarios under which deviation from patterns of prior cash flows are appropriate.
3. The Department should continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.
4. Efforts to more fully implement cohort reporting should continue, with specific research on whether balances in the Department's financial records are supported by estimates, by cohort, from the SLM and the newly developed cohort analysis tool. Analytical tools should be developed to assure that the splitter process is operating as intended and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.

2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of the Department's FY 2006 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

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The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, the GAO publication states that:

- “management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management,” and
- “internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved.”

While the Department has made progress in strengthening controls over information technology processes and has continued making improvements in the areas of configuration management, virus protection, and security patch management during FY 2006, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses, including several that were repeat conditions, within information technology security and systems that need to be addressed.

More specifically the Department should: (1) strengthen access controls to protect mission critical systems (e.g. user provisioning process, periodic access revalidation, timely removal of user access, physical data center access controls); (2) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; (3) enforce the use of complex passwords in all systems across the organization; (4) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization; (5) implement consistent tape back up controls; (6) strengthen security incident handling procedures and intrusion detection systems; (7) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location or a new system; (8) improve private data protection controls (e.g. proper disclosure of the use of ‘cookies’ on Department websites and policies and procedures on dial up access and encryption of back up data); (9) enhance its security training and awareness program and the monitoring of this program, specifically in accounting for completion of such training by all employees and contractors; (10) improve protection of sensitive information, including read-only access to personally identifiable information on Department systems; and (11) the Office of Management should continue its efforts to reconstruct its inventory database or otherwise reconcile its physical inventory of computing and other equipment to ensure that all Department computing resources and the data residing in them are secured and safeguarded.



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Report on Internal Control

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The OIG has identified significant deficiencies for the Department in its 2006 Federal Information Security Management Act (FISMA) report in the areas of (1) the Department's management control structure in incident handling and intrusion detection systems which restrict its ability to reasonably identify and report suspicious activity; and (2) the Department's configuration management program that restricts its ability to reasonably maintain security over its systems in a consistent manner. In addition, a number of repeat conditions were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department require additional focus.

Recommendation:

1. Audit resolution activities have traditionally been focused around addressing the immediate security and control weaknesses identified by audit reports rather than a detailed evaluation of the root cause for the identified weaknesses, which is indicated by the number of repeat findings. We recommend that the Department continue its efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness, which should decrease the likelihood of a similar weaknesses being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, updates to procedures to ensure proper configuration of servers against documented hardening standards at the time of deployment, and auditing performance-based contracts of vendors providing system support services to the Department.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2005 audit of the Department of Education's financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:



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Summary of FY 2005 Reportable Conditions

Issue Area	Summary Control Issue	FY 2006 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Reportable Condition)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Improvements noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements noted – Modified Repeat Condition Reportable Condition

We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 7, 2006.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department’s OIG, and is not intended to be and should not be used by anyone other than these specified parties.

November 7, 2006



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Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2006, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 7, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States; 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*.

The management of the Department is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, 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, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03. We noted certain other matters involving compliance with laws and regulations that were reported to management in a separate letter dated November 7, 2006.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

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Report on Compliance with Laws and Regulations

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The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. We have identified the following instance of noncompliance:

While the Department has made progress in strengthening controls over information technology processes and has continued making improvements in the areas of configuration management, virus protection, and security patch management during FY 2006, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses, including several that were repeat conditions, within information technology security and systems that need to be addressed. More specifically, the Department should: (1) strengthen access controls to protect mission critical systems (e.g. user provisioning process, periodic access revalidation, timely removal of user access, physical data center access controls); (2) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; (3) enforce the use of complex passwords in all systems across the organization; (4) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization; (5) implement consistent tape back up controls; (6) strengthen security incident handling procedures and intrusion detection systems; (7) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location or a new system; (8) improve private data protection controls (e.g. proper disclosure of the use of 'cookies' on Department websites and policies and procedures on dial up access and encryption of back up data); (9) enhance its security training and awareness program and the monitoring of this program, specifically in accounting for completion of such training by all employees and contractors; (10) improve protection of sensitive information, including read-only access to personally identifiable information on Department systems; and (11) the Office of Management should continue its efforts to reconstruct its inventory database or otherwise reconcile its physical inventory of computing and other equipment to ensure that all Department computing resources and the data residing in them are secured and safeguarded.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives.



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Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

November 7, 2006





UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-_____

NOV - 8 2006

MEMORANDUM

TO: John P. Higgins, Jr.
Inspector General

FROM: Lawrence A. Warder
Chief Financial Officer 
Bill Vajda 
Chief Information Officer

SUBJECT: DRAFT AUDIT REPORTS
Fiscal Years 2006 and 2005 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17G0003

Please convey our sincere thanks and appreciation to everyone on your staff who worked diligently on this financial statement audit. The Department has reviewed the draft Fiscal Years 2006 and 2005 Financial Statement Audit Reports. Without exception, we concur and agree with the Internal Control Report and the Auditor's Opinion. We also concur and agree with the report on Compliance with Laws and Regulation.

We will share the final audit results with responsible senior officials, other interested program managers, and staff. At that time we will also request that they prepare corrective action plans to be used in the resolution process.

Again, please convey our appreciation to everyone on your staff whose efforts permitted the Department to complete the audit within the accelerated timeframe. Please contact Gary Wood at (202) 401-0862 with questions or comments.



Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

Other Accompanying Information

Improper Payments Information Act Reporting Details

The *Improper Payments Information Act of 2002* (IPIA) and the Office of Management and Budget's (OMB) Circular No. A-123, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments*, require agencies to annually review and assess all programs and activities to identify those susceptible to significant improper payments. The guidance in OMB Circular No. A-123, Appendix C, defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and \$10 million annually. For each program identified as susceptible, agencies are required to report to the President and the Congress the annual amount of estimated improper payments, along with steps taken and actions planned to reduce them.

To facilitate agency efforts to meet the reporting requirements of the IPIA, the OMB announced a

new *President's Management Agenda* program initiative beginning in the first quarter of FY 2005 entitled Eliminating Improper Payments. Previously, the OMB tracked the Department's IPIA activities with other financial management activities through the Improving Financial Performance initiative. The establishment of a dedicated *President's Management Agenda* initiative focused the Department's improper payments efforts. Under the new initiative, the Department's status and progress are tracked and reported to the OMB in quarterly scorecards.

The Department has divided its improper payment activities into the following segments: Student Financial Assistance Programs, Title I Program, Other Grant Programs, and Recovery Auditing.

Student Financial Assistance Programs

Federal Student Aid operates and administers the majority of the *Higher Education Act of 1965*, as amended (HEA), Title IV¹ Student Assistance (Title IV) programs for the Department. In FY 2006, nearly \$77 billion was provided to students and families to help them overcome the financial barriers that make it difficult to attend and complete postsecondary education. Federal Student Aid administers a variety of grants, loans, and loan guarantees through its financial assistance programs. The processes developed to administer the programs are responsive to changes in statutes, the reauthorization of existing statutes, and the changing needs of educational institutions and their students.

Title IV student assistance programs are large and complex. Federal Student Aid relies on over 6,100 eligible postsecondary institutions, 3,200

lenders, 35 loan Guaranty Agencies, and a number of private loan servicers to administer its programs. Except for funds received as an administrative cost allowance, Federal Student Aid program funds received by a school are held in trust by the school for the students, the Department, and, in some cases, for private lenders and Guaranty Agencies.

The HEA and subsequent Department regulations to implement the law comprise a succession of eligibility definitions, standards, requirements, tests, and other internal controls designed to minimize the risk that improper payments will be made either to students or to postsecondary or financial institutions. The law provides criteria for an institution to be eligible to participate in student financial assistance programs and mandates the joint responsibility of a program integrity triad made up of state educational agencies, accrediting agencies, and the Department. This structure, while empowering educational institutions to operate programs based on area needs, can increase the

¹ Title IV is the portion of the Higher Education Act that authorizes and regulates various student financial aid programs.

risk of improper payments and pose oversight and monitoring challenges for the federal government.

Federal Student Aid engages in a continual process of actively identifying new risks in the programs it administers. Noncompliance with statutes, regulations and policies, whether by students, schools, lenders, Guaranty Agencies, or loan servicers, not only places Title IV funds at risk, but also erodes public trust in the programs. To address these concerns, Federal Student Aid has several initiatives underway to identify real or potential risks for fraud, waste, abuse, mismanagement, and inadvertent errors in the delivery of student financial assistance programs and funds.

Controls Over Financial Aid Applications

Over 13 million postsecondary school students apply for federal student aid each year by completing the required *Free Application for Federal Student Aid (FAFSA)*. Information provided on the *FAFSA* is used to (1) calculate the expected family contribution (EFC), an amount applicants and their families are expected to contribute to the cost of their postsecondary education expenses for a given award year, and (2) confirm eligibility through computer matches with other agencies. Unless the application is rejected due to inconsistencies or inadequate information, the Department's central processing system will automatically calculate the EFC. The HEA establishes the formula for the EFC calculation. The result is a measure of the applicant's financial strength, and is significant in the determination of the amount and type of aid a student can receive.

The Department processes the *FAFSA* data it receives each year, using a sophisticated set of database matches and computerized editing techniques to confirm student eligibility for the Title IV programs and to target error-prone applications for a verification process. All applicants are subjected to one or more of the student eligibility database matches and approximately 30 percent (approximately 3.9 million) are selected for verification.

Those applicants selected for verification are required to submit documentation to their school in order to verify their reported household size,

number of family members attending college, adjusted gross income (AGI), U.S. income taxes paid, and certain untaxed income and benefits reported on the *FAFSA*. Schools are required to collect copies of income tax returns from applicants who file returns (and their parents, if the applicant is a dependent student) to determine that AGI, income taxes paid, and certain untaxed income and benefits amounts were correctly reported on the *FAFSA*. Any discrepancies detected during the verification process must be corrected.

Risk Assessment

As required by the IPIA, Federal Student Aid inventoried its programs during FY 2006, and reviewed program payments made during FY 2005 (the most recent complete fiscal year available), to assess the risk that a significant amount of improper payments were made. The review identified and then focused on five key programs (Federal Family Education Loan Program, Federal Pell Grant Program, Federal Supplemental Educational Opportunity Grant and Federal Work-Study Programs, and Direct Loan Program), representing 98.7 percent of Federal Student Aid's FY 2005 outlays. (Outlays in this context represent the amount of money actually spent during a fiscal year.)

The criteria for determining susceptible risk within the programs were defined as follows:

- For those programs with annual outlays that did not exceed the OMB susceptibility threshold of \$10 million, a comprehensive program risk assessment was not prepared and the programs were determined to be unsusceptible to the risk of significant improper payments.
- For programs with outlays greater than \$10 million, but less than \$200 million, estimates of improper payments were prepared using the susceptible threshold error rate of 2.5 percent. Programs with improper payment estimates of less than \$5 million were deemed unlikely to be susceptible to the risk of significant improper payments.
- Programs were selected for further determination of susceptibility to significant

improper payments if annual outlays exceeded \$200 million.

- Finally, programs were automatically deemed susceptible if previously required to report improper payment information under OMB Circular A-11, *Budget Submission*, former Section 57.²

Risk Susceptible Programs

The following five Title IV programs were deemed to be potentially susceptible to the risk of significant improper payments based on the OMB threshold of potential annual improper payment amounts exceeding both 2.5 percent of program payments and \$10 million.

Federal Family Education Loan Program.

The Federal Family Education Loan (FFEL) Program is a guaranteed loan program established by the HEA. Under the FFEL Program, eligible students apply to lenders such as banks, credit unions, and savings and loan associations for loans to vocational, undergraduate, and graduate schools to help pay for educational expenses. If the lender agrees to make the loan, a state or private nonprofit loan Guaranty Agency insures the loan against default. The federal government subsequently reinsures this loan. FFEL Programs offer various repayment options and provide four types of loans to qualified applicants.

- Subsidized Stafford Loans—Need-based loans in which the government pays interest when the student is in school and during qualified periods of grace and deferment.
- Unsubsidized Stafford Loans—Loans in which the government does NOT pay interest.
- PLUS Loans—Loans to parents of dependent undergraduate students in which

the government does not pay interest. As a result of the *Higher Education Reconciliation Act of 2005*, graduate or professional students are now eligible to borrow under this loan program, subject to eligibility.

- Consolidated Loans—Loans that allow borrowers to combine multiple outstanding federal student assistance loans.

During FY 2006, net loans of \$46.2 billion were provided to 6.2 million FFEL recipients. In addition, Federal Student Aid paid an estimated \$7.5 billion to lenders for interest and special allowance subsidies, and an estimated \$4.6 billion to Guaranty Agencies to reimburse them for defaulted FFEL loans, loan processing fees, issuance fees, and account maintenance fees required by the HEA. The interest payments and special allowance subsidies, combined with the default, loan processing, issuance, and account maintenance fees comprise the program outlays at risk.

Federal Pell Grant Program. The Federal Pell Grant (Pell Grant) Program provides need-based grants to low-income undergraduate and certain postbaccalaureate students to promote access to postsecondary education. Students may use their grants at any one of approximately 6,100 eligible postsecondary institutions. Grant amounts are dependent on the student's EFC, the cost of attending the institution, whether the student attends full-time or part-time, and whether the student attends the institution throughout the entire academic year. The statutory maximum award remained at \$4,050 for the 2005-2006 award year.

Under the terms of the HEA, eligibility for Pell Grant awards is determined exclusively through applicant self-reported income, family size, number of dependents in college, and assets. These data are key drivers in the determination of program eligibility and eligible amounts. However, historical analysis indicates that the accuracy of self-reported data is prone to error, and that these errors subsequently increase the risk of improper payments within the Pell Grant program.

While limited matching of some self-reported income data is currently conducted with data

² The four original programs identified in OMB Circular A-11, Section 57 were Student Financial Assistance (now Federal Student Aid), Title I, Special Education Grants to States, and Vocational Rehabilitation Grants to States. Subsequently, after further review of the program risk, the OMB removed Special Education Grants to States and Vocational Rehabilitation Grants to States from the list. The OMB considers Section 57 programs susceptible to significant improper payments regardless of the established thresholds.

from the Department of the Treasury, Internal Revenue Service (IRS) annual income tax filings, Federal Student Aid is pursuing additional authority to allow greater access to IRS data. Specifically, Federal Student Aid has requested authorization to verify 100 percent of the annual student financial aid applications with the financial data reported to the IRS in annual income tax returns. The ability to verify self-reported financial data could result in a significant reduction of the risk of improper payments in the Pell Grant program. Legislation to amend the Internal Revenue Code to permit a 100 percent data match has not yet been enacted, and at this time appears unlikely to be enacted. In the interim, Federal Student Aid is working with the OMB to develop alternative methods.

Federal Supplemental Educational Opportunity Grant and Federal Work-Study Programs.

The Federal Supplemental Educational Opportunity Grant program is one of three campus-based³ formula grant programs allocated to eligible institutions for the purpose of providing grants to needy undergraduate students attending the institution. During FY 2005, the Department allocated \$1 billion through the Federal Supplemental Educational Opportunity Grant program to institutions who awarded grants to about 1.3 million low-income students.

The Federal Work-Study program is another of the three campus-based formula grant programs, providing part-time employment to needy undergraduate and graduate students. In FY 2006, the Department allocated \$1.2 billion to schools.

The Federal Supplemental Educational Opportunity Grant and Federal Work-Study programs were surveyed and determined not to be of significant risk of improper payments. Combined, the two programs constituted \$2.3 billion, or just 2.6 percent of the Department's total payments in FY 2005. Each year, participating institutions complete the *Fiscal Operations Report and Application to Participate*. The *Fiscal Operations Report and Application to Participate* serves as a

mechanism to report prior year funds usage and current year need. Each year, the aggregated amount of need (for all participating institutions) far exceeds the appropriated amounts for both Federal Supplemental Educational Opportunity Grant and Federal Work-Study programs. Therefore, by design, the risk of over-awarding funds is inherently minimized since award distribution is prioritized by order of need, and not all students with demonstrated need actually receive awards. Moreover, continuing oversight activities, including audits and program reviews, have not revealed significant risk in either of these programs.

William D. Ford Federal Direct Loan Program.

Similar to the FFEL Program, the William D. Ford Federal Direct Loan (Direct Loan) Program provides the following four types of loans to qualified individuals to assist with the cost of postsecondary education: (1) Stafford Subsidized; (2) Stafford Unsubsidized; (3) PLUS; and (4) Consolidation.

Under the Direct Loan Program, the Department uses Department of Treasury funds to provide loan capital directly to schools, which then disburse loan funds to students. During FY 2005, the Department disbursed \$13.9 billion in Direct Loans (net of loan consolidations) through participating institutions to 1.8 million applicants with financial need who met the program criteria.

Similar to the Pell Grant Program, improper payments in the Direct Loan Program are generally the result of errors in the self-reported eligibility data provided on the *FAFSA*. However, since the aid is provided as a loan rather than a gift, and is subject to full repayment (some loans including interest), eligibility errors alone do not necessarily result in a significant loss to the government.

Moreover, the authority of the Department to successfully pursue the collection of defaulted loans (properly or improperly made) through tax refund offsets, wage garnishment offsets, and other legal actions further reduces the government's risk. The principal risk to the government lies in the cost of administering the loans and the subsidy—the net present value of cash flows to and from the government that result from providing these loans to borrowers.

³ Campus-based financial aid programs are administered to students by participating postsecondary institutions and not by the Department of Education.

The Department contracts with multiple educational and financial institutions to originate, disburse, service, and collect Direct Loans, while the HEA and subsequent reauthorization actions determine the allowable interest rates and fees. Eligibility requirements are determined through the analysis of factors such as income and assets, and the schools make the final award decisions. Because of this multifaceted structure that encompasses multiple entity involvement and variable annual eligibility requirements, a full and rigorous assessment of the rate of improper payments in the Direct Loan Program is extremely complex. Despite this challenge, the Department is analyzing the eligibility data used to determine the Pell Grant improper payment rate as part of its comprehensive effort to lower the risk of improper payments in all financial aid programs that are reliant on applicants' self-reported eligibility information.

Academic Competitiveness/SMART Grants.

In FY 2006, Federal Student Aid program managers discussed the potential risks and controls for avoiding improper payments in the recently authorized Academic Competitiveness /SMART Grant program. Payment processes and risk categories have been identified. In addition, a risk control matrix has been developed for these new programs.

Federal Student Aid Administrative

Payments. As part of our annual assessment of risk for the susceptibility of significant improper payments, we reviewed other types of payments made by Federal Student Aid. An initial review of the administrative payments such as payroll disbursements, vendor payments, and travel expenses determined that those payments were not susceptible to the risk of significant improper payments, as defined by IPIA and the related OMB implementation guidance.

Statistical Sampling

The size and complexity of the student aid programs make it difficult to consistently define "improper" payments. The legislation and the OMB guidance use the broad definition, "Any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other

legally applicable requirement." Federal Student Aid has a wide array of programs, each with unique objectives, eligibility requirements, and payment methods. Consequently, each program has its own universe (or multiple universes) of payments that must be identified, assessed for risk, and, if appropriate, statistically sampled to determine the extent of improper payments.

Federal Family Education Loan Program.

The Department and Federal Student Aid have been working with the OMB on the implementation of the *President's Management Agenda* initiative, Eliminating Improper Payments. The initiative involves a range of quarterly activities designed to ensure that the Department is prepared to meet the annual reporting requirements of the IPIA. Through meetings and discussions with the OMB and other Department offices, Federal Student Aid finalized its sampling methodology for estimating improper FFEL program payments in compliance with the requirements of the IPIA and implementation guidance.

In FY 2006, Federal Student Aid identified and performed an internal review of all invoices included in the statistically valid sample. All of the Guaranty Agencies and lenders associated with each of the invoices in the selected samples were identified. Twenty-one Guaranty Agencies and 47 lenders have been identified for on-site reviews, which will be conducted in FY 2007. Program review staff from Federal Student Aid's Program Compliance business unit have been identified to perform the on-site reviews.

For FY 2005, Federal Student Aid established a baseline of estimated improper payments in the FFEL Program by evaluating the following information:

- Overpayments identified during Financial Partners Service program reviews of Guaranty Agencies, lenders and loan servicers during FY 2005.
- Overpayments identified by independent public accountants and third-party audit

firms in Single Audit⁴ reports for Guaranty Agencies and lenders.

- Overpayments reported by the Department's Inspector General in audits and reviews of Guaranty Agencies, lenders, and loan servicers during FY 2005.
- Outstanding loan balance amounts at Guaranty Agencies, lenders, and servicers selected for review.

The preliminary estimated rate for the FFEL Program is 2.2 percent. This estimate was derived based on an evaluation of the criteria aforementioned.

The information was compiled by entity and compared to the total payments made to those entities in fiscal year 2005 to determine if there exists a susceptibility to significant improper payments. The focus of this analysis was to (1) determine a baseline error rate for FFEL payments, (2) establish an action plan for improving the accuracy of future measurements, and (3) ensure that the planned methodology and approach for measuring improper payments meets the requirements of the IPIA.

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

Federal Pell Grant Program. Section 484(q) of the HEA authorizes the Department to confirm directly with the IRS the AGI, taxes paid, filing status, and number of exemptions reported by students and parents on the *FAFSA*. Under the IRS Code, Federal Student Aid is not authorized to view the complete data, but is provided with summary data by the IRS.

The Department began routinely conducting studies with the IRS using *FAFSA* data for the

2000-2001 award year. Data provided by the IRS study were used to estimate improper payments for the Pell Grant Program for the 2004-2005 award year. Federal Student Aid is currently working with the IRS on the fifth annual study, using *FAFSA* data collected for the 2005-2006 award year, which will be matched with IRS data for the 2004 income tax year. (Applicants for the 2005-2006 award year reported income information based on their actual or estimated 2004 income tax year.)

In the latest completed study, which compared 2004-2005 *FAFSA* data with 2003 IRS data, a sample file of 155,000 *FAFSA* applicant records was provided to the IRS along with a sampling program designed to allow the IRS to select the desired analysis sample from the larger file. This was done to preserve IRS confidentiality requirements. The final sample, generated by the IRS, contained 50,000 independent undergraduates and 50,000 dependent undergraduates (for whom parental data was matched).

The IRS matched the final sample to its main database, and when a match occurred, it extracted the fields for AGI, taxes paid, type of return filed and earned income tax credit information for the tax filer and compared this information to similar information reported to the Department on the *FAFSA*. Using a computer program supplied by Federal Student Aid, the IRS calculated revised EFC and Pell Grant awards for matching records by substituting the IRS income information for the *FAFSA* income information. The IRS provided aggregated statistical tables to the Department that presented the results of these comparisons. The results allowed the Department to estimate the following Pell Grant improper payment information:

- Improper payment rate and amount—The average amount of over- and under-reporting of *FAFSA* income data—as compared to the IRS income data—and the potential dollar amount of improper Pell Grant awards;
- Assessment of measurement accuracy—The volume of applicants for whom a mismatch between *FAFSA* and IRS data may be legitimate;

⁴ "Single audit" means an audit, which includes both the entity's financial statements and the federal awards pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. The provisions of the statute are set forth in OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

- Identification of further potential risks—Types of applicants who are more likely to misreport income on the *FAFSA*;
- Analysis of existing edits—Validity of the current verification selection edits, and information to further refine them.

The table below presents a historical analysis of the results of the IRS Statistical Study of Pell Grants.

Pell Grant Improper Payment Estimates							
(\$ in millions)							
Fiscal Year	Disbursements	Underpayments	Overpayments	Total Improper Payments*	Percent Underpayments*	Percent Overpayments*	Percent Total Improper Payments*
2001	\$ 9,851	\$ 64	\$272	\$336	.8%	3.4%	4.2%
2002	\$11,619	\$ 49	\$328	\$378	.5%	3.3%	3.8%
2003	\$12,680	\$205	\$365	\$569	1.8%	3.1%	4.9%
2004	\$13,042	\$221	\$349	\$571	1.8%	2.8%	4.5%
2005	\$12,749	\$140	\$303	\$444	1.1%	2.38%	3.48%
*Amounts are rounded							

William D. Ford Federal Direct Loan Program. The analysis and corrective actions developed for the Pell Grant Program, relative to application accuracy, will also improve the accuracy of Direct Loan program applications, because (1) the same application is used for both programs, and (2) eligibility for subsidized direct loans are founded on the same need-based analysis formula and institutional cost of attendance. Federal Student Aid, in coordination with the OMB, performed an assessment of the risk of improper payments based upon the comparison of school cash draws with loan disbursements for FY 2005. This assessment showed that the risk of improper payments in this function has decreased from

2003-2004 to 2004-2005 and is minimal at this time. However, we recognize the importance of being vigilant in analyzing data reported to the Department. The strengthening of verification to improve the accuracy of applicant reported data will have an effect on reducing improper payments in all Title IV programs, including the Federal Direct Loan Program.

Corrective Actions

Federal Family Education Loan Program.

Federal Student Aid is working closely with the OMB and other Department offices in the development of an action plan designed to (1) improve the accuracy of the FFEL improper payment estimate, and (2) reduce the level of risk and the amount of known improper payments in the FFEL Program. Understanding and developing systems of internal controls over program payments is crucial to these goals.

Federal Student Aid has a number of existing internal controls integrated into its systems and activities. Program reviews, independent audits and Inspector General audits of Guaranty Agencies, lenders, and servicers are some of its key management oversight controls. Other control mechanisms in place are described below.

- System Edits—the systems used by the Guaranty Agencies, lenders, and servicers to submit fee bills for payment include “hard” and “soft” edits to prevent erroneous information from being entered into the system and translated into erroneous payments. The hard edits prevent fee bills with certain errors from being approved, and these errors must be corrected before proceeding with payment processing. The soft edits alert the user and Federal Student Aid to potential errors. Federal Student Aid reviews these warnings prior to approval of payment.
- Reasonability Analysis—data stored in the National Student Loan Data System are used as a tool to assess the reasonability of fee billing, and to determine payment amounts

for account maintenance and loan issuance processing fees paid to Guaranty Agencies. Federal Student Aid also performs trending analysis of previous payments to Guaranty Agencies, lenders and servicers, as a means of evaluating reasonableness of changes in payment activity and payment levels.

- Focused Monitoring and Analysis—Federal Student Aid targets specific areas of FFEL payment processing that are at an increased risk for improper payments as areas of focus for increased monitoring and oversight.

These existing controls are re-evaluated on a regular basis to determine their effectiveness and to allow Federal Student Aid to make necessary corrections. Further, Federal Student Aid's action plan incorporates the development of additional internal controls designed to improve the accuracy of future FFEL payments to lenders, servicers, and Guaranty Agencies.

- Special Allowance Payments – increased focus and review of payments of fees to lenders and servicers associated with loans eligible for tax-exempt special allowance payments.
- Guaranty Agencies – enhanced review of the Guaranty Agency Financial Report (Form 2000) to report collection activities, claims reimbursement, and loan portfolio status; and under- and over-billings for account maintenance, loan issuance, and processing fees associated with incorrect National Student Loan Data System reporting.

Additional controls are being considered for both cost efficiency and effectiveness in reducing FFEL payment errors. Updates to the corrective action plan will be reported to the OMB in the quarterly scorecard for *Eliminating Improper Payments*.

Federal Pell Grant Program. Federal Student Aid has several initiatives underway designed to improve its ability to detect and reduce improper payments made in the Pell Grant Program. Working with the OMB on quarterly action plan objectives designed to facilitate full implementation of the IPIA, it has identified additional methods to determine the error rate and to estimate the annual amount of improper

payments.

Preliminary Analysis. Eligibility for Title IV student aid is determined through applicant self-reported income, family size, number of dependents in college, and assets. These data are reported through the *FAFSA*, which applicants typically complete prior to the April 15 IRS tax filing deadline. The *FAFSA* data are key drivers in the determination of student aid program eligibility and eligible amounts. Federal Student Aid performs regular analysis on the accuracy of income and other financial data submitted via the *FAFSA*. These routine analyses include a variety of methods and techniques designed to ensure payment accuracy.

- Annual Analysis of System Data - Analysis of central processing system data for anomalies.
- Focus Groups - Meetings with educational institutions to discuss improving the integrity of FSA programs.
- Quality Assurance - Enhanced program integrity processes.
- Verification - A process by which institutions compare applicant data to IRS data for the same period.

Federal Student Aid is also using the IRS statistical study in which financial data from a random sample of *FAFSA* submissions is compared to financial data reported to the IRS in annual income tax filings to identify new solutions for preventing improper payments.

The analysis of the IRS statistical study indicates that failure to accurately report income, family size, number of dependents in college, and assets may be the primary cause of improper payments within the Pell Grant Program. It is expected that a decrease in financial reporting errors would have the greatest impact on the reduction of estimated improper payments. In an effort to achieve this reduction, Federal Student Aid has requested authorization to perform a 100 percent match of the financial data reported on the *FAFSA* to the financial data reported to the IRS on applicant income tax returns. However, current law does not permit Federal Student Aid to verify income data with the IRS. Although

Federal Student Aid plans to pursue this option, it must continue to meet the reporting requirements of the IPIA. Federal Student Aid is pursuing alternatives that will accomplish the same result: reduced improper payments in the Pell Grant Program.

Alternatives to Verifying Self Reported AGI.

Federal Student Aid, working with officials from the OMB and the Department, has been exploring alternatives to the 100 percent IRS match for verifying self-reported financial information reported on the *FAFSA*, and assessing the strengths and weaknesses of those alternatives. Listed below are some of the alternatives that are being considered:

- Private database matches (data aggregators).
- Require actual tax returns for *FAFSA* filing.
- Require update to income data at tax filing deadline.
- Expand verification beyond 30 percent.

The ongoing action plan details the steps necessary to (1) perform statistical analysis, (2) complete the review of the alternative, (3) incorporate current IRS statistical analysis, and (4) submit the recommended alternative or combination of alternatives. Progress in completing actions will continue to be reported to the OMB in the quarterly scorecard for *Eliminating Improper Payments*.

Federal Student Aid's ability to project improper payment reductions is wholly dependent upon the completion of the corrective action plan and the selection of an alternative approach to a 100 percent IRS income match for every application. This will not be a quick or easy process. It is important to note that the system development life cycle for the pertinent Federal Student Aid systems requires significant lead time for requirements, testing, coding and implementation of changes required to deploy the changes necessary to reduce improper payments.

William D. Ford Federal Direct Loan

Program. While the risk of significant improper payments in the Direct Loan Program has been considered minimal, Federal Student Aid developed a separate action plan to achieve IPIA reporting elements for this program during FY 2006. Assessment of the risk of improper payments in the Direct Loan Program was based upon an evaluation of the annual audits required of the schools participating in the programs. Information on all audits was queried from Postsecondary Education Participants Systems, our management information system of all schools participating in the student aid programs. Audit deficiencies resulting in liabilities due to a specific Direct Loan Program violation or due to a violation of regulations applicable to all programs were isolated. The liability amount for each deficiency applicable to the Direct Loan Program was calculated and compared with total funding.

The contractor's correction plan verified that incorrect payments were identified by completing two separate reviews of all National Student Loan Data System sourced certifications. This review verified that incorrectly disbursed funds were recovered, or are in the process of being recovered. In addition, the contractor reviewed the loan servicing accounts of both the underlying loans that were Direct Loans and the resulting consolidation loans to ensure that correcting transactions being passed from loan consolidation resulted in complete correction of the borrowers' accounts, and no adverse impact was imposed on the borrower. This review included ensuring that borrowers' progress toward and eligibility for on-time payment incentives was not affected, and that payments were correctly reapplied following receipt of the correcting transaction.

Federal Student Aid Summary

The following table presents the improper payments outlook for the primary Federal Student Aid Programs.

Federal Student Aid Improper Payment Reduction Outlook Fiscal Years 2005 – 2009															
(\$ in millions)															
	Actual						Estimated								
	2005			2006			2007			2008			2009		
Program	Outlays ¹	IP %	IP \$	Outlays	IP %	IP \$	Outlays	IP %	IP \$	Outlays	IP %	IP \$	Outlays	IP %	IP \$
Direct Loan Program	\$12,231	NA ²	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
FFEL Program ⁴	\$8,626	2.2%	\$190	\$18,245	2.2%	\$401	\$5,340	2.2%	\$117	\$5,340	2.2%	\$117	\$5,340	2.2%	\$117
Pell Grant Program	\$12,749	3.48% ³	\$444	\$12,117	3.48%	\$422	\$12,825	3.48%	\$446	\$12,825	3.48%	\$446	\$12,825	3.48%	\$446

¹ Outlays reported in the table have been adjusted to reflect actual disbursements of funds, net of internal and intra-governmental adjustments or transfers.

² Federal Student Aid is working with the OMB and other Department offices to determine whether a statistically valid estimate of improper payments is necessary for the Direct Loan Program.

³ Combined over- and under-payment error rate is 3.48 percent. A separate analysis of the overpayments and underpayments was previously presented in the Pell Grant table.

⁴ Federal Student Aid is working to update future year improper payment estimates as the methodology is further developed.

Manager Accountability

Federal Student Aid program managers are responsible for making recommended improvements and achieving quantifiable savings. The Federal Student Aid Executive Management Team monitors these efforts. The Executive Management Team is composed of key managers and is the executive decision-making body within Federal Student Aid. Further, the Office of Inspector General conducts periodic audits of student aid programs and makes appropriate recommendations to management and the Congress.

Reducing improper payments in the Pell Grant Program has been a performance measure in the Department's Strategic Plan since 2002. The IRS statistical study has also been included in Federal Student Aid's Annual Plans. In addition, projects have been included in the Federal Student Aid Annual Plan to improve the verification process results.

Beginning in 2005, a control group of *FAFSA* applicants who had estimated their 2004 income when completing the application were advised after April 15 to revise the application with the correct and known information filed on their 2004 income tax return.

Statutory or Regulatory Barriers

As stated previously, a database match with the IRS would likely improve the accuracy of Pell Grant awards. In addition, it would eliminate the need for schools to rely on paper copies of tax returns submitted by the applicant (and the applicant's parent, if the applicant is dependent) to verify AGI and taxes paid amounts. However, legislation to amend the Internal Revenue Code to permit the database match has not yet been enacted and at this time appears unlikely to be enacted.

Title I

The Department performed a risk assessment of the *Elementary and Secondary Education Act* Title I Program, parts A, B, and D, during FY 2006. The *Erroneous Payments Risk Assessment Project Report* documented that the risk of improper payments under the current statutory requirements is very low. In order to validate the assessment data, the Department conducted an on-site monitoring review in FY 2006 that encompassed all states and territories receiving Title I funds with a three-year review cycle. The Office of the Chief Financial Officer participated with the Office of Elementary and Secondary Education in the monitoring process, beginning March 2005, to provide technical support regarding fiduciary compliance. There were no findings in the monitoring reviews with questioned costs that contradicted the data in the risk assessment.

The Department is continuing to review and monitor for data quality. A key element of the monitoring process involves the wide use of the number of children who qualify for free and reduced price meals to determine an individual school's Title I eligibility and allocation by local educational agencies. The Title I statute authorizes local educational agencies to use these data, provided under U.S. Department of Agriculture's National School Lunch Program, for this purpose. In many districts these data are the only indicator of poverty available at the individual school level.

Currently, the U.S. Department of Agriculture is working with states and localities to improve program integrity, within the existing statutory and regulatory framework, through enhanced monitoring and auditing to improve program integrity. The U.S. Department of Agriculture is also working with the Department and other federal agencies that have programs that make use of these data to explore long term policy options.

Manager Accountability

In fiscal year 2006, the Department used a database of the OMB Circular A-133 single audit findings to provide feedback to program managers regarding the frequency and distribution of findings within their programs. This will assist the managers in tailoring their program monitoring efforts to the type of findings that most frequently occur. Additionally, a new grants monitoring training course is now offered and a post-audit follow-up overview course is currently being developed to improve the usefulness of OMB Circular A-133 single audits to the Department.

The Department also plans to develop manager's internal control training that will focus on controls to eliminate improper payments. The mandatory one-day seminar for all Department managers will provide a framework for administering the improper payment controls program utilizing applicable regulations, guidelines, and best practices. Part of this one-day training will focus on the utilization of the risk assessment criteria to properly assess the risk of improper payments in the Department's programs.

Planned Corrective Actions

In addition to the actions previously outlined under the Federal Student Aid Programs and Title I sections, the Department will configure our corrective action plans based on the results of the initiatives outlined above. The Department will record and maintain corrective action plans as required. These records will include due dates, process owners, and task completion dates.

Information Systems and Infrastructure

The Department has requested \$450,000 for FY 2007 and \$450,000 for FY 2008 in our budget submission for information system infrastructure improvements. A portion of the funds will be used to continue the refinement of

the Oak Ridge National Laboratory data mining effort. It is also anticipated that the Department will incur costs related to mitigation activities.

Remaining Grant Programs

During FY 2006, the Department expanded and strengthened its approach to evaluating the risk of improper payments associated with its remaining grant programs. The Department continued to work with the Department of Energy's Oak Ridge National Laboratory to perform data-mining on information available in the Federal Audit Clearinghouse's Single Audit Database, the Department's Grant Administration and Payment System, and the Department's Audit Accountability and Resolution Tracking System.

The Department's approach to the risk assessment process for non-Federal Student Aid grant programs was to develop a methodology to produce statistically valid measures that could be applied uniformly across the Department's programs. The intent is to use the same methodology across all non-Federal Student Aid grant programs to establish a level of quality control for all programs and at the same time produce a cost effective measure. The Department deemed it cost effective to utilize the results of the thousands of single audits already being performed by independent auditors on grant recipients.

FY 2006 Improvement to Risk Assessment

One of the concerns that resulted from the FY 2005 Oak Ridge National Laboratory study is the definition of what constitutes a "program." The Department's original definition was at a high level in order to effectively match anticipated outlays as defined in our budget submissions and consequently grouped many Catalogue of Federal Domestic Assistance (CFDA) numbers into a single "functional program." The concern with this definition was

that calculating estimated improper error rates at that high of a level can effectively mask the potentially higher rates that might exist if a "program" is defined to mean the CFDA level. To further refine the Department's methodology, Oak Ridge National Laboratory was tasked to perform the FY 2006 risk assessment at the CFDA level in addition to the functional program level. The details of this analysis are available from the Office of the Chief Financial Officer upon request.

Another change implemented for the FY 2006 review was to count all costs identified as questioned costs in single audits as improper payments. The FY 2005 assessment reduced the questioned costs by one half to account for the questioned costs that are not sustained during the audit resolution process. Although it was reasonable to adjust the questioned costs downward to account for the low percentage of sustained questioned costs, the Department determined a more conservative approach better serves the intent of the IPIA. In addition, the risk assessment is designed to establish the upper bound of improper payments for the programs.

Risk Assessment

To conduct the risk screening, Oak Ridge National Laboratory augmented the *Audit Accountability and Resolution Tracking System* database with imputed values for the "likely questioned costs" for grants that were not audited. The imputed and real questioned costs could then be tabulated to provide a reasonable upper bound estimate of the rate of erroneous payments for each of the functional programs of interest. If the computed upper bound percentage is below 2.5 percent, then the actual

value will be lower than 2.5 percent. If the computed upper bound percentage is greater than 2.5 percent, then the actual value may be greater or less than 2.5 percent but the Department will need additional information to determine the appropriate estimate.

The key results of the analysis are presented in the chart. It contains the estimates of the average functional program rates of questioned costs for recent years. The most striking point about the table is the generally low rate of questioned costs. With only one exception, the rates are below 2.5 percent. The key finding of this analysis is that for the most recent year for which data are available (FY 2004), none of the functional programs exceeds the threshold value of 2.5 percent. The assessment at the CFDA level revealed similar results. Consequently, none of the programs should be labeled as a high-risk program.

Managing Risk in Discretionary Grants

In FY 2006, the Department managed more than 10,000 discretionary grant awards. Due to the vast legislative differentiation and the complexity of the Department's grant award programs, ensuring that our program staff are fully aware of potentially detrimental issues relating to individual grantees is a significant challenge. Program offices must occasionally designate specific grants as high-risk, following collaboration with the respective program legal counsel and the Department's Grants Policy and Oversight Staff.

In an effort to ensure efficiency and reduce risk, the Department has established the Grants High-Risk Module. This module is housed within the Department's Grant Administration and Payment System, such that program office staff are required to review and certify their awareness of the high-risk status of applicable grantees before making awards.

Policies and procedures were developed to support implementation of the high-risk module.

System input to the module's database is limited to specific grants policy staff who are fully trained in policy and system use. In addition to the module's certification requirement, various reports are provided such that continual monitoring of grantee risk is made available to

Grant Program Improper Payment Estimates				
Functional Program	%			
	2001	2002	2003	2004
Education Research, Statistics & Assessment	0.00	0.02	0.36	0.0
Elementary & Secondary Education	0.13	0.12	0.13	0.6
English Language Acquisition	0.00	0.02	0.10	0.1
Higher Education	2.72	0.29	0.21	0.4
Impact Aid	0.00	0.55	0.04	0.4
Innovation and Improvement	0.28	0.21	0.23	0.1
Rehabilitation Services & Disability Research	0.07	0.12	0.32	2.1
Safe & Drug-Free Schools	0.37	0.33	0.13	1.2
Special Education	0.09	0.06	0.83	0.1
Title I	0.04	0.16	1.19	0.2
Vocational & Adult Education	0.20	0.25	0.12	0.2
Total	0.06	0.04	0.16	0.4

Department program administrators.

Implementation of the module provides greater accountability and significantly reduces risk within the Department's grant award process by ensuring program office awareness of potentially detrimental grantee issues prior to award determination. We anticipate that increased accessibility of information and communication across our program offices will promote further monitoring of high-risk grantees, such that the number of grantees so designated will decline.

Recovery Auditing Progress

To effectively address the risk of improper administrative payments, the Department continued a recovery auditing initiative to review contract payments. All vendor payment transactions made from FY 1998 through FY 2005 were reviewed. Potential recoveries

are minimal. Fiscal year 2006 payments will be reviewed during FY 2007. Our purchase and travel card programs remain subject to monthly reviews and reconciliations to identify potential misuse or abuse.

Summary

The Department of Education is continuing its efforts to comply with the *Improper Payments Information Act*. While there are still challenges to overcome, the Department has demonstrated in FY 2006 that it is committed to ensuring the integrity of its programs. The Office of Management and Budget recognized our progress in managing improper payments when the Department's implementation progress scorecard was raised to green on the *President's Management Agenda* initiative for Eliminating Improper Payments.

The Department is focused on identifying and managing the risk of improper payment problems and mitigating the risk with adequate control activities. In FY 2007, we will continue to work with the OMB and the Inspector General to explore additional methods for identifying and reducing potential improper payment activity in our programs, and to ensure compliance with the IPIA.

Report to Congress on Audit Follow-up

The *Inspector General Act*, as amended, requires that the Secretary report to the Congress on the final action taken for the Inspector General audits. With this *Performance and Accountability Report*, the Department of Education is reporting on audit follow-up activities for the period October 1, 2005, through September 30, 2006.

The *Audit Accountability and Resolution Tracking System* is the Department's single database system used for tracking, monitoring, and reporting on the audit follow-up status of the Government Accountability Office audits; the Office of Inspector General issued internal audits, external audits, and alternative products; and Single Audits of funds held by non-federal entities. The Department's audit follow-up system functionalities allow the following:

- Tracking of internal, external, sensitive, and alternative product types from inception to final disposition.
- Evaluation and escalation points for audit reports and recommendations at appropriate levels in the user hierarchy.
- Notifying users of audit decisions and approaching or expiring events and transactions.
- Downloading report and query results into electronic file formats.
- Attaching files to the audit record.
- Providing a personal portal (Digital Dashboard) for user-assigned transactions.
- Providing a search function to query application (Audit Report) data.
- Providing for both a defined and an ad hoc report generation environment.

Number of Audit Reports and Dollar Value of Disallowed Cost

At the start of this reporting period, the balance for audit reports with disallowed costs totaled 59, representing \$34.3 million. At the end of the reporting period, the outstanding balance was 72 audits, representing \$42.9 million. The

information in the table below represents audit reports for which receivables were established.

Final Actions on Audits with Disallowed Costs Fiscal Year Ended September 30, 2006		
	Number of Reports	Disallowed Costs
Beginning Balance as of 10/1/2005	59	\$ 34,285,141
+ Management Decision	192	28,670,284
Pending Final Action	251	\$ 62,955,425
- Final Action	179	20,078,463
Ending Balance as of 9/30/2006	72	\$ 42,876,962

Number of Audit Reports and Dollar Value of Recommendations That Funds Be Put to Better Use

The Department has a total of 9 audit reports of which one is under review. The remaining 8 audit reports totaling \$254 million with recommendations that funds be put to better use. Only 4 of these, totaling \$12.5 million, have been resolved. Resolution occurs when there is agreement between the program office and the Department's Office of Inspector General on the corrective actions that will be taken to address all of the recommendations in the audit.

Reports Pending Final Action One Year or More After Issuance of a Management Decision

As of September 30, 2006, the Department has a total of eight Office of Inspector General internal and nationwide audit reports on which final action was not taken within a year after the issuance of a management decision; 62 percent were less than two years old. Many corrective actions are dependent upon major system changes that are currently being implemented. For detailed information on these audits, refer to the Department's *Semiannual Report to Congress on Audit Follow-up Number 35*.

Credit Management and Debt Collection Improvement Act

The Department of Education has designed and implemented a comprehensive credit management and debt collection program that enables us to effectively administer our multi-billion-dollar student loan and other programs. The credit management and debt collection program covers each phase of the credit cycle—including prescreening of loan applicants, account servicing, collection, and close-out—and it conforms to the government-wide policies in the Federal Claims Collection Standards, the Office of Management and Budget Circular No. A-129, “*Managing Federal Credit Programs*,” and the *Debt Collection Improvement Act*. As a result, the Department has made significant strides in student loan default management and prevention.

The Department has been working diligently with schools and partners in the student loan industry to reduce the cohort default rate. The fiscal year 2004 cohort default rate is 5.1 percent. The low default rate is a function of the Department’s improved borrower counseling and the steps we have taken in gate keeping to remove schools with high rates from participating in the federal student loan programs.

Borrowers who default on student loans face serious repercussions, such as the withholding of federal income tax refunds and other federal payments, wage garnishment, adverse credit bureau reports, denial of further student aid, and prosecution. To avoid these sanctions, defaulters have the option to consolidate their loans and establish an income-based repayment plan that more realistically matches their ability to pay.

The Department also continues to conduct computer matches with other federal agencies as part of our effort to strengthen the management and oversight of student financial assistance programs. The computer matches are designed to ensure that students meet various eligibility criteria and to increase the collections from students who have defaulted on their loans.

The Department categorizes debt into two basic categories: student loan debt, which accounts for approximately 99 percent of all of the Department’s outstanding debts, and institutional and other administrative debt. The Department of Treasury granted the Department a permanent exemption from the cross-servicing requirements of the *Debt Collection Improvement Act* for defaulted student loans and approval to continue to service our own internal student loan debts because of our successful track record. However, we have been referring eligible student loan debts—those we previously tried to collect using all other available tools—to the Department of Treasury for tax refund offset since 1986.

The Department handles our institutional and administrative debts outside of the systems established for student loans. The Department was one of the first to participate in the Treasury Cross Servicing Program and has been referring delinquent debts since October 1996. As of September 30, 2006, we have forwarded approximately 95 percent of all institutional and administrative debts eligible for cross servicing to Treasury.

OTHER ACCOMPANYING INFORMATION


MANAGEMENT CHALLENGES



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MEMORANDUM

TO: Secretary Margaret Spellings
FROM: John P. Higgins, Jr. 
RE: Management Challenges for Fiscal Year 2007
DATE: October 25, 2006

Pursuant to the *Reports Consolidation Act of 2000*, we provide the attached report, Management Challenges for the U.S. Department of Education for Fiscal Year 2007. We look forward to working with you to address these challenges and improve the efficiency and integrity of the Department's programs and operations.

Attachment
Cc: Senior Officers

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202-1510

OTHER ACCOMPANYING INFORMATION

MANAGEMENT CHALLENGES

MANAGEMENT CHALLENGES FOR FISCAL YEAR 2007

The Office of Inspector General (OIG) works to promote efficiency, effectiveness, and integrity in the programs and operations of the U.S. Department of Education (Department). Through our audits, inspections, investigations, and other reviews, we have identified areas of concern within the Department's programs and operations and have recommended actions the Department should take to address these weaknesses. The Department generally implements our recommendations and takes action to recover funds from grantees, contractors, and other recipients we identify as wrongly paid. While our work is a valuable tool for the Department, it is not a substitute for good management and organizational accountability.

The *Reports Consolidation Act of 2000* requires OIG annually to identify and summarize the top management and performance challenges facing the Department, as well as to provide information on the Department's progress in addressing those challenges. Based on our recent work and knowledge of the Department's programs and operations, we have identified three specific challenge areas for the Department for FY 2007: (1) accountability; (2) information technology; and (3) human resources (HR). While this report discusses the progress the Department is making in addressing these challenges, it is evident that additional focus, attention, and emphasis are needed.

1. ACCOUNTABILITY

Challenge: Internal Control and Oversight

The success of an organization's mission and the achievement of its goals depend on how well it manages its programs. It cannot effectively manage its programs without establishing and maintaining appropriate internal accountability. In 1999, the Government Accountability Office released "*Standards for Internal Control for the Federal Government*," a document that provides federal agencies with an overall framework for establishing and maintaining internal controls, *i.e.*, the plans, methods, and procedures that will help the organization meet its goals and achieve its objectives.

Our recent audits, inspections, and investigations continue to uncover problems with program control and oversight of program participants, placing billions of taxpayer dollars at risk of waste, fraud, abuse and non-compliance. The Department must ensure that all entities involved in its programs are adhering to statutory and regulatory requirements, and that the offices responsible for administering these programs are providing adequate oversight of program participants. Only by improving effective oversight of its operations and demanding accountability by its managers, staff, contractors, and grantees can the Department be an effective steward of the billions of taxpayer dollars supporting its programs and operations.

The Department's Progress: The Department has made some progress toward improving oversight and monitoring of non-student financial assistance programs. For the *Elementary and Secondary Education Act (ESEA)* Title I program, the Department's monitoring plan now includes participation by staff from the Office of the Chief Financial Officer to provide technical support in the fiduciary area of the reviews. In a review of audited questioned costs and analysis of improper payments, the Department is no longer reducing questioned costs by 50 percent to establish an estimated amount of sustained costs, but is correctly using the full amount to better establish an upper bound of improper payments. The Department also has implemented a Grants High-Risk Module within the Grant Administration and Payment System to better alert program offices of potentially detrimental grantee issues prior to award determination.

To address internal control issues identified by our work, Federal Student Aid (FSA), the office that administers the student financial assistance programs, made changes to the organizational structure of one of its internal offices, Financial Partners, and transferred the regional offices out of Financial Partners to a

new Program Compliance organization. The functional statements for the new organizations, however, indicate overlapping jurisdiction and do not clearly delineate responsibility for resolving compliance violations.

Challenge: Improper Payments

Improper payments include those made in the wrong amount, payments made to an ineligible recipient, or payments improperly used by the recipient. The need for agencies to take action to eliminate overpayments is recognized by the President's Management Agenda, as well as the *Improper Payments Information Act of 2002*. Identifying and correcting improper payments remains a challenge for the Department, which is a result of ineffective oversight and monitoring of its policies, programs and program participants.

The Department's Progress: To address the requirements of the *Improper Payments Information Act*, the Department continued to participate in presentations or perform monthly monitoring site visits for its *ESEA* Title I program at various state and local educational agencies. It also continued to enlist the help of the Oak Ridge National Laboratory to perform its risk analysis of its non-student financial assistance programs. The 2006 Oak Ridge National Laboratory Report indicated that the Title I program was not at risk of exceeding the 2.5 percent *Improper Payments Information Act* threshold that would require further statistical review. The Department is also performing on-site monitoring reviews for its *ESEA* Title III program.

With regard to the student financial assistance programs, FSA has undertaken several initiatives to help address and reduce improper payments. Some of these efforts have included a continued focus on controls over financial aid applications; performing risk assessments; working with the Office of Management and Budget (OMB) and the Department on a quarterly basis to address various *Improper Payment Information Act* implementation issues, such as the sampling methodology for estimating improper payments; conducting studies with the Internal Revenue Service; focused monitoring activities; and performing various analyses of certain data in the FSA programs. For the most recent year, 2004-05, FSA reported an improper payment rate for the Pell Grant program of 3.48 percent, down from 4.5 percent for the prior year. FSA also is taking steps to identify risks and establish controls to avoid improper payments in a new program – the Academic Competitiveness/SMART Grant program.

Challenge: Procurement

The Department contracts for many services that are critical to its operations, at a value of close to \$1 billion a year. The Department must improve its procurement and contract management processes to ensure that it is receiving quality goods and services in accordance with the contract terms. Our audit work continues to find weaknesses in the Department's processes for monitoring contractor performance, such as not effectively tracking and inspecting deliverables, paying for deliverables that were not provided, not adequately reviewing invoices, improperly providing incentive payments, giving unauthorized instructions to the contractor, not informing the contracting officer of changes in key personnel, and not documenting evaluations of contractor reports.

The Department's Progress. In response to OIG's continuing audits of the contracting monitoring processes, the Department issued a new procedure requiring that contract monitoring plans be developed for all new contracts. This procedure was issued in December 2005, and also required that contract monitoring plans be developed for all existing contracts by January 31, 2006. In March 2006, the Department updated its policy, *Contract Monitoring for Program Officials*, to correct issues noted in prior OIG reviews.

2. INFORMATION TECHNOLOGY

Challenge: Information Security

The *Federal Information Security Management Act (FISMA)* requires each federal agency to develop, document, and implement an agency-wide program to provide information security for the information and information systems that support the operations and assets of the agency, including those provided or managed by another agency, contractor, or other source. It also requires the Inspectors General to perform an annual, independent evaluation of its agency's information security program and practices.

We have conducted *FISMA* compliance audits for the last four years. In each case, we identified security weaknesses that the Department must address to maintain the security certification and accreditation of its systems. We determined that certain management, operational, and technical security controls need improvement to adequately protect the confidentiality, integrity, and availability of its systems. We have identified weaknesses in the Department's incident handling process and procedures, intrusion detection system deployments, and enterprise-wide technical configuration standards for all systems. In addition, we found that its outsourced data centers do not have adequate security controls and safeguards in place to protect personally identifiable information (PII) and other sensitive information that is stored on its system tape backups. During a related audit, we also found that the office in the Department that had the highest number of contractors in FY 2005 had not ensured that all contractor staff met screening requirements before giving them access to the Department data and facilities. These deficiencies must be addressed in order to maintain the security certification and accreditation of its systems, as well as to protect PII and other sensitive information.

The Department's Progress: The Department continues to struggle to establish a mature computer security program in the areas of developing technical configuration standards for all its systems, managing its outsourced contractors who operate its critical information systems, and ensuring the identification and response to its incident handling program and intrusion detection systems.

The Department recently established plans to improve its controls relating to the protection of PII in order to meet the standards and good practice requirements established by OMB. Budget and contracting constraints have negatively impacted the Department in moving forward with improving these controls.

Challenge: Information Technology Capital Investment and Project Management

The Department's anticipated FY 2007 Information Technology (IT) capital investment portfolio is over \$90 million, and many critical IT projects are pending, including investments in the Office of the Chief Financial Officer, the Office of the Chief Information Officer, and FSA. It is critical that the Department have a sound IT investment management control process that can ensure that technology investments are appropriately evaluated, selected, justified, and supported. This oversight and monitoring process must address IT investments as an agency-wide portfolio. It must also ensure that individual projects are appropriately managed so as to meet their technical and functional goals on time and on budget. As part of this process, the Department must identify a means of conducting independent evaluations of significant IT projects. Independent Verification and Validation (IV&V) could be a viable approach, if the IV&V results are shared with the Investment Review Board for its consideration. Poor management of individual IT investments leads to wasted resources and/or unreliable or inadequate systems.

The Department's Progress: While the critical issue of independent assessment remains unaddressed, the Department has recently strengthened the IT capital investment program by expanding the Investment Review Board and Planning and Investment Review Group memberships. The Department has also made

MANAGEMENT CHALLENGES

continued efforts to strengthen individual business cases, and to map proposed investments to an agency-wide enterprise architecture strategy. These efforts are important and should continue.

3. HUMAN RESOURCES

Challenge: Human Capital Management and Human Resources Services

Our last several Management Challenges reports have included human capital planning as one of the significant challenges facing the Department. Like most federal agencies, the Department will see a significant percentage of its workforce eligible for retirement in 2007. The Department is also continuing to see a significant change in critical skill requirements for many of its staff. Identification of needed action steps and prompt implementation of action items to adequately address these workforce and succession planning issues, including recruitment, hiring and retention, is critically important.

The Department has already committed considerable time and resources to prior HR initiatives -- One-ED and the HR most efficient organization -- that were minimally beneficial, if at all. In order to address the HR issues facing it, the Department must be willing to commit adequate resources.

The Department's Progress: In January 2006, the Secretary approved a request from FSA to set up an independent HR function on a pilot basis. Also this year, the Department focused on performance management and worked with all Department managers to improve their understanding of performance agreements and ratings. It hired a Deputy Human Capital Officer who is focused on improving HR issues throughout the Department. We understand that it will soon release a new strategy for improving HR.