Report of the Independent Auditors

NOV 15 2007

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

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 2007 and 2006, 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, 2007 and 2006, 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,

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, 2007 and 2006, and the related consolidated statements of net cost, and changes in net position, 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. 07-04, *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.

As further discussed in Note 1 to the financial statements, pursuant to guidance issued by the OMB, certain information reconciling the net cost of operations to budgetary obligations which was previously reported in a consolidated statement of financing for the fiscal year ended September 30, 2006, has been presented in the notes to the financial statements along with the corresponding amounts for the fiscal year ended September 30, 2007.

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, 2007 and 2006, and its net costs, changes in net position, and budgetary resources, for the years then ended, in conformity with accounting principles generally accepted in the United States.

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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 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 13, 2007, 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.

Ernst + Young LLP

November 13, 2007

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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, 2007, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 13, 2007. 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. 07-04, *Audit Requirements for Federal Financial Statements.*

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04. 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. 07-04 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal control 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. 07-04. 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.

Our consideration of internal control over financial reporting was for the limited purposes described in the preceding paragraphs and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described below to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described above and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe none of the significant deficiencies described below is a material weakness.

SIGNIFICANT DEFICIENCIES

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, 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 2007, we noted that the Department made significant progress on certain aspects of this significant deficiency, including further documentation of the inputs to the Department's computer based cash flow projection model, and further refinement of the process used to analyze the products of the newly instituted cohort level analytic tools and comparison of general ledger activity to model cash flows. These are significant steps in enhancing the Department's knowledge.

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The Credit Reform Workgroup (CRW) was created in FY 2004 to improve the credit reform estimation process. During FY 2007, senior management of the CRW continued to meet regularly to discuss the direction of credit reform efforts. Concurrently, the Department streamlined the three sub-groups of the CRW into monthly integrated loans program meetings. Managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), Budget Service, Office of Postsecondary Education (OPE), and OMB established a series of monthly meetings to review reports developed to enhance credit reform discussions and to discuss key internal issues and trends related to the portfolios. Information and analyses were reviewed as inputs into the assumptions to the credit reform models. The group recommended 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 can 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 also produces a forecast of the expected cash flows in the current year for the outstanding loans which, when discounted, can be used to compare to the recorded activity in the general ledger. The new data analysis tools prepared by the Department support more disaggregated reviews of data by cohort. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. 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 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.

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- 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 may not repeat. To the extent that lender or borrower behavior appears likely to have changed, or be changing, deviations from the use of historical data, or introduction of additional assumptions to capture the impact of such changes may be warranted in developing credit reform estimates. For example, pending obtaining definitive participant information regarding which program participants will continue to bill for special allowances related to loans funded by tax-exempt obligations issued before October 1, 1993, the Department, while adjusting assumptions to reflect the Department's settlement activity, has largely continued to project such cash flows as occurring based on historical experience in developing its estimates for the FFEL program. There are indications that not all such lenders will continue to pursue such payments.

  Similarly, the last few months have seen a considerable change in the housing and mortgage lending markets. Increasing delinquencies and stagnating home prices have led to concerns about not just the state of these markets, but also concerns about effects on the broader economy. These events may have an impact on student loan borrowers and consequently on the Department's credit reform results.

  Since the Department's approach to estimating deferment, forbearance, and default rates includes unemployment and inflation rates for selected loan products, and since forecasts of these external factors are used in arriving at the projected deferment, forbearance, and default amounts, the Department's estimates would be expected to capture some of the indirect impact of the credit and housing market deterioration. However, since the models are estimated using data that largely do not reflect recessionary conditions, and since the external factors are not included in all models, the Department could gain additional insights by performing stress-testing around its estimates. This could be achieved by, for example:

  - *Cohort Analysis.* Since differences may exist in how the events in the housing market and broader economy impact borrowers at various points in their career, examining deferment, forbearance, and default rates by cohort may be beneficial. This could be achieved by comparing the rates at the same point in repayment for newer loans to those of older loans. This exercise would provide information regarding the extent to which there may be differences in performance across cohorts. Obtaining credit rating data for a subset of borrowers may also be useful in furthering analysis and tracking borrowers' ability to pay over time.

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- *Examining Behavior During Previous Periods of Economic Stress.* Though the data used in the Department's estimation generally reflects good economic conditions, they also cover at least two periods of economic changes from which information may be gathered to assess the potential impact of the current situation. The housing market downturn in the late 1980s and early 1990s may provide insights into the effect, if any, that housing market conditions may have on the deferment, forbearance, and default rates of student loans. Similarly, the economic effects of the bursting of the dot com bubble in the early 2000s may be illustrative of the impact of a potential economic slowdown. Although neither one of these events is a perfect analog to the current situation, they may provide useful information for stress-testing the Department's deferment, forbearance, and default estimates.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process and in periodic meetings of the Credit Reform Workgroup. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
2. Continue efforts to more fully implement cohort reporting 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 and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.
3. Document the consideration and ultimate resolution, in detail, of scenarios under which deviation from patterns of prior cash flows may be appropriate in developing credit reform estimates.

2. Additional Focus on Program Monitoring Activities is Needed

Renewed focus is warranted regarding monitoring activities for various Departmental loan and grant programs. Several audits and inspections were conducted by the Department's Office of Inspector General (OIG) in FY 2006 and 2007 of participants in the Department's programs and oversight and monitoring performed by the Department for such programs. These audits and inspections identified issues regarding potential noncompliance with program requirements and deficiencies in program oversight processes. In some cases the focus on such programs has led to changes in how programs are administered; and settlements have occurred with program participants including, in 2007, activity related to the Department's refinement of the eligibility requirements specified by the Higher Education Act of 1965, as amended, for receiving tax-exempt special allowance payments.

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The OIG reports include suggestions for improvements in areas such as policy development and dissemination, program monitoring and oversight of guaranty agencies, lenders and servicers that participate in the Federal Family Education Loan (FFEL) program, and also noted matters for improvement in program monitoring for grant programs. Certain potential non-compliance issues in the OIG reports are currently under consideration by Department management. In some instances, management informed us that corrective actions had been implemented or were in the process of being implemented to address some of the issues raised by the OIG.

The overarching theme in these reports suggests that the Department and FSA should revisit and reinvigorate as appropriate the processes they use to monitor their programs. Funding, disbursements, and loan portfolio balances for certain grant and loan programs have all increased over the past several years, which also suggests a need for additional monitoring and revisiting periodic risk assessments for each unique program.

Recommendations:

We recommend that the Department of Education perform the following:

1. The Department and FSA should continue to re-assess oversight and monitoring practices to include a specific focus on the risks of each program in connection with its evaluation and assessment of internal control. This process should also address risks identified in other assessment, audit and inspection activities. The identified risks and the controls identified to mitigate such risks, both of which should be thoroughly documented, serve as a starting point for identifying appropriate improvement initiatives. The Department and FSA should continue and refine efforts we were informed are underway to identify and implement, as appropriate, additional changes needed in the approach to program management, including procedures for performing program and monitoring reviews, and reviews of payments to FFEL lenders and guaranty agencies prior to disbursement as appropriate.

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

In connection with the annual audit of the Department's FY 2007 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 worked towards strengthening and improving controls over information technology processes during FY 2007, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems that need to be addressed. The OIG has identified deficiencies for the Department in its 2007 Federal Information Security Management Act (FISMA) report in the areas of (1) FSA's management control structure in incident handling and intrusion detection systems which restrict its ability to reasonably identify and report suspicious activity; (2) FSA's configuration management program that restricts its ability to reasonably maintain security over its systems in a consistent manner; (3) FSA's oversight of contractors supporting select systems; and (4) the Department's safeguarding of personally identifiable information. Comments were also noted regarding the Certification and Accreditation process, risk assessments and security status of interconnected systems, and an assessment that in some instances the Department had not conducted oversight commensurate with the potential risks to the Department.

More specifically, based on our work and the findings of the OIG, 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 and two factor authentication as appropriate; (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) strengthen security incident handling procedures and intrusion detection systems; (6) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location, upgrading to a new system, or every three years as required by National Institute of Standards and Technology (NIST) guidance; (7) improve controls over the protection of personally identifiable information (PII) (e.g. encryption of backup data and monitoring of contractors who may have access to PII);

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(8) enhance monitoring of its security training and awareness program, specifically around completion of such training by all employees and contractors; (9) ensure that all personnel, employees and contractors, undergo appropriate background investigation checks and formally acknowledge the Department's rules of behavior prior to gaining access to any Department system or facility; (10) implement standards around the logging of privileged user access and activities and establish controls over the monitoring of that access, and (11) update its contingency planning and disaster recovery planning documentation.

The number of repeat conditions noted in our work and in the OIG's audit reports is an indication that the control environment and monitoring components of internal controls at the Department require additional focus.

Recommendation:

1. Applications and related infrastructure are supported by a number of separate groups within the Department and FSA. While these groups have attempted to implement controls promulgated by Department, FSA, OMB, and NIST guidelines, control processes and practices have been implemented in a disparate manner across these groups. In addition, audit resolution activities have traditionally been performed by each separate group and have largely 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. 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 uniformly across the organization, 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 2006 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 2006 Reportable Conditions

Issue Area	Summary Control Issue	FY 2007 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 classified as a Significant Deficiency
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements noted – Modified Repeat Condition classified as a Significant Deficiency

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 significant deficiencies described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 13, 2007.

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 13, 2007

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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, 2007, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 13, 2007. 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. 07-04, *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. 07-04, 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. 07-04.

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.

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:

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Page 2

While the Department has worked towards strengthening and improving controls over information technology processes during FY 2007, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including 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 and two factor authentication as appropriate; (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) strengthen security incident handling procedures and intrusion detection systems; (6) consistently perform risk assessments and Certification and Accreditation on its new systems and new environments, especially after migrating to a new location, upgrading to a new system, or every three years as required by National Institute of Standards and Technology (NIST) guidance; (7) improve controls over the protection of personally identifiable information (PII) (e.g. encryption of backup data and monitoring of contractors who may have access to PII); (8) enhance monitoring of its security training and awareness program, specifically around completion of such training by all employees and contractors; (9) ensure that all personnel, employees and contractors, undergo appropriate background investigation checks and formally acknowledge the Department's rules of behavior prior to gaining access to any Department system or facility; (10) implement standards around the logging of privileged user access and activities and establish controls over the monitoring of that access, and (11) update its contingency planning and disaster recovery planning documentation.

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. We did not audit management's proposed action plan and accordingly, we express no opinion on it.

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.

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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 13, 2007

UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-______

NOV 9 2007

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 2007 and 2006 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17H0003

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 2007 and 2006 Financial Statement Audit Reports. Without exception, we concur and agree with the Report of Independent Auditors and the Report on Internal Control. We also concur and agree with the Report on Compliance with Laws and Regulations.

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 my 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.

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