

Archived Information



Report of Independent Auditors



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 12 2004

Honorable Roderick Paige
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

The enclosed reports present the results of the annual audits of the U.S. Department of Education's financial statements for fiscal years 2004 and 2003, 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 to audit the financial statements of the Department as of September 30, 2004 and 2003, 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 FFMIA, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report dated November 10, 2004, 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 white background.

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.

Report of Independent Auditors



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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, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement 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 Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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, 2004 and 2003, and its net cost, 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 Discussion and Analysis of the Department, required supplementary stewardship information, and required supplementary information is not a required part of the basic financial statements but is supplementary information required by Office of Management and Budget Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. 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.

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In accordance with Government Auditing Standards, we have also issued our reports dated November 10, 2004, 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 10, 2004
Washington, D.C.



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Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2004 and 2003, and the related consolidated statement of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 10, 2004.

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. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal control, determined whether this internal control had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal control 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. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

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 these controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB 01-02 and not to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

Finally, with respect to internal control related to performance measures reported in the Management 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. 01-02. 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 the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants and OMB

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Bulletin No. 01-02, reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Department's ability to record, process, and report financial data consistent with the assertions by management in the financial statements. A material weakness is a reportable condition in which the design or operation of one or more of the specific 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. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be reportable conditions. However, none of the reportable conditions are believed to be material weaknesses. The remainder of this report details the reportable conditions.

REPORTABLE CONDITIONS**1. Improvements of Credit Reform Estimation and Financial Reporting Processes are Needed (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 were made over the last several years, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined and implemented earlier in the process to ensure that appropriate estimates are prepared. OMB Circular A-123 defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

During FY 2004, we noted that the Department made significant progress on this reportable condition. Early in FY 2004, the Department created a formal Credit Reform Workgroup (CRW) which consisted of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to Credit Reform, and manage the development of improved processes, procedures and sources of information to enhance the credit reform estimation process.



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While the CRW has made progress in many areas, the work is still ongoing. In FY 2005, the Department will continue to focus on improving and documenting the processes used to arrive at cost estimates. A primary focus for the upcoming fiscal year is to refine the processes used to develop assumptions in the model, that appropriate review procedures are in place within the Budget Service area, and that the entire loan estimation process is documented for transparency. The end objective is a well-defined process, which includes appropriate and robust checks and edits, as well as documentation of key decisions and rationales.

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 costs estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long term cost for the Direct Loan (DL) program is reflected on 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 DL receivable. 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 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. After reviewing this “backcast”, we noted that the estimated cash collections developed by the model for the DL program for FY 2004 and prior years were greater than actual collections by a significant amount. The Department has indicated that an increase in deferments/forbearances and income-contingent repayment plans in the DL program are the primary reason for the delay of the actual receipt of payments. The Department is reviewing whether additional sources of information are needed and/or modifications to the assumptions used are required. The output from this new process to model collections will be an important component in the calculations used to determine the net present value of direct loans.
- A key detection control used by the Department for the loan program estimation process are analytical tools, such as the backcast mentioned above; these tools are used to assess the validity of the estimates derived by the SLM and OMB calculator. One of these analytical tools is the forecast, which illustrates the timing of the estimates of collections or disbursements for the loan program in the years occurring after the current fiscal year. The information for the forecast is derived from data developed directly from the model. As a check, the Department should be able to reconcile the total amounts in the forecast to the allowance for subsidy and liability for loan guarantees. However, we noted that some of the analyses prepared by the Department were not appropriately reconciled with one another; specifically for the Federal Family Education Loan (FFEL) program. In order for analytical tools to provide useful information and to serve the purpose as a detection control for the Department such analysis should contain accurate information.



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- 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. During our review of these programs, we noted that the programming language was not 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.
- Many phases must be completed before the cost estimates are calculated for the loan programs. Most of these phases occur in the Budget Service area and include the cooperation of mathematicians, statisticians, and economists. During our testing of the various phases of the loan estimation process, we noted that no formal review process was documented for a significant amount of information prepared by Budget Services. Further, we noted a calculation error in a spreadsheet that was subsequently adjusted by the Department. We noted that the CRW has begun working on detailed operating procedures for the loan estimation process in FY 2004. Without sufficient documentation of operating and review procedures the loan estimation process may be prone to mechanical and significant errors.
- 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 does not currently have a method to be better informed as to whether the resulting split is occurring properly on an overall basis. The development of additional analytical tools in this area could provide additional assurance as to whether the model is operating as intended.

Recommendations:

We recommend that the Department of Education perform the following:

1. Reassess and modify the model for DL collections, which would appropriately project the timing of estimated total collections. These revisions should ensure that collections for all types of payment plans are taken into account when developing cost estimates. Also, evaluate whether additional sources of data are needed for modeling collections. If



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further alignment of actual and estimated collections is necessary for DL, then appropriate re-estimate adjustments should be developed.

2. 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.
3. Document in detail the programs written to develop the assumptions for the SLM. Documentation should allow an informed reader or reviewer to understand the purpose of the procedures being executed, in order to diminish the potential of logic errors in the program's output.
4. The Department, including Budget Service, 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.
5. Analytical tools should be developed to assure the splitter process, as described above, is operating as intended.

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

In connection with the annual audit of the Department's fiscal year 2004 financial statements, we conducted a controls review of the information technology (IT) 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.

The Office of Inspector General reported in the October 2004 audit report, *Department of Education's Implementation of FISMA – Fiscal Year 2004* (control number ED-OIG/A11-E0002), that the Department has made progress in addressing control weaknesses identified in prior audits. OIG has reported that the Department has made progress in several areas, including: finalizing system security plans, configuration management plans, and continuity/disaster recovery plans that support the agency-wide Information Security Program and Certification and Accreditation program; taking corrective action of security weaknesses reported in its Plan of Action and Milestones updates to OMB; assessing the viability of its Continuity of Operations and Business Continuity Plans; and implementing procedures for periodically testing and evaluating network level information security and implementing network intrusion detection systems.



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Although progress has been made with respect to information technology controls, our work and the OIG findings reinforce that continuous effort is needed to further address control weaknesses related to information technology and systems. The OIG identified the Department's Certification and Accreditation process as a significant deficiency in its 2004 Federal Information Security Management Act (FISMA) report. The Department disagreed with the OIG's assessment of its Certification and Accreditation process. In particular, the following recommendations for improvements were noted for the Department:

- The Department's mission critical servers need to be consistently updated with the latest application version updates, virus/data integrity protection packages, and security patches.
- The use of complex passwords should be enforced on all systems across the enterprise.
- Network and host based intrusion detection systems should be deployed to provide meaningful alerts of potential network intrusions and malicious internal network activity.
- Access controls should be strengthened to protect certain mission critical systems.
- Configuration management processes can be improved to ensure consistent security configurations of servers across the enterprise and configuration settings.
- Technical security weaknesses identified in prior audits should be comprehensively reviewed to determine whether security controls have been fully implemented or adequately address the security weaknesses.
- The Certification and Accreditation process at the Department needs to be improved. Specifically, the Department should utilize security tools in determining whether system security weaknesses have been corrected and the Department should improve its oversight of contractors performing the C&A.

Recommendation:

We recommend that the Department continue efforts to address the security weakness identified by the OIG's FISMA report. Specifically, the Department should implement actions to address the issues outlined above.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2003 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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Figure 1: Summary of FY 2003 Reportable Conditions

Issue Area	Summary Control Issues	FY 2004 Status
Improvement of Financial Reporting Related to Credit Reform is Needed (Reportable Condition)	Management controls and analysis need to be strengthened over financial reporting related to credit reform.	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 10, 2004.

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 10, 2004
Washington, D.C.



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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 sheets of the U.S. Department of Education (the Department) as of September 30, 2004 and 2003, and the related consolidated statement of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended, and have issued our report thereon dated November 10, 2004.

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. 01-02, *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. 01-02, 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. 01-02.

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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Report on Compliance with Laws and Regulations

Page 2

The Department has made progress in strengthening controls over information technology processes during FY 2004. However, our work and audit reports prepared by the Office of Inspector General (OIG) identify certain control weaknesses over information technology security and systems that need to be addressed. More specifically the Department should: (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission critical systems; (4) improve the configuration management process to ensure consistent security configuration of servers across the organization and improve configuration settings to comply with best practices; (5) 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; and (6) improve management and implementation of the Department's Certification and Accreditation process.

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 Office of Inspector General in accordance with applicable Department directives.

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.

A handwritten signature in cursive script that reads 'Ernst & Young LLP'.

November 10, 2004
Washington, D.C.



UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-_____

NOV 10 2004

MEMORANDUM

TO: John P. Higgins, Jr.
Inspector General

FROM: Jack Martin *Jack Martin*
Chief Financial Officer

William Leidinger *William Leidinger*
Assistant Secretary for Management and Chief Information Officer

SUBJECT: DRAFT AUDIT REPORTS
Fiscal Years 2004 and 2003 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17E0006

Please convey my 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 2004 and 2003 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, except as noted in our report.

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 Terry Bowie at 401-4144 with questions or comments.



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