



ANNUAL REPORT

2007

U.S. Department of Education | Federal Student Aid



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FEDERAL STUDENT AID™

Dear Federal Student Aid Colleagues, Partners and Customers,

I am pleased to present the 2007 Annual Report for Federal Student Aid detailing the accomplishments of Federal Student Aid during the 2007 federal fiscal year. It serves as both a guide for our future endeavors and an accountability tool to ensure that our endeavors match our organizational objectives. The report is designed to summarize our performance in the management and administration of the Title IV student financial assistance programs.

The accomplishments in this report reflect the commitment, hard work and dedication of approximately 1,000 Federal Student Aid employees. I would like to specifically acknowledge my predecessor, Theresa S. Shaw, for her five years of strong leadership at Federal Student Aid and for her dedication to improving the quality and delivery of Federal Student Aid products.

As the number of students enrolled in college continues to increase, we anticipate more customers requiring our products and services. Federal Student Aid will continue to pursue its mission to identify new business processes and procedures, innovative system solutions, best-practice risk management approaches and ground-breaking contracting solutions to improve customer service, reduce the cost of administering the Title IV programs while limiting the vulnerability of these programs to fraud, waste, abuse and mismanagement.



Larry Warder
Acting Chief Operating Officer

Sincerely,

A handwritten signature in black ink that reads "L. A. Warder".

Lawrence A. Warder
Acting Chief Operating Officer

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Management's Discussion and Analysis

Mission and Organizational Structure

Federal Student Aid, a principal office of the U.S. Department of Education (the Department), ensures that all eligible individuals can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans – and its value to our society. Federal Student Aid plays a central and essential role in supporting postsecondary education. We partner with postsecondary schools, financial institutions and other participants in the Title IV student financial assistance programs (Title IV programs) to deliver programs and services that help students finance their education beyond high school. Today, Federal Student Aid is responsible for a range of critical functions that include, among others:

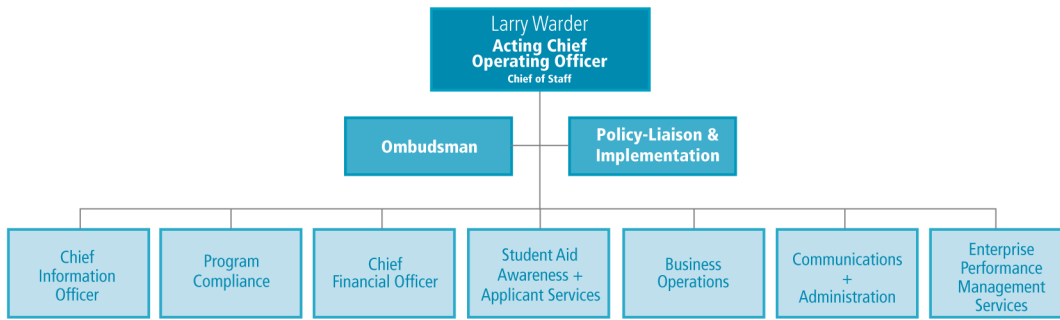
- Processing millions of student financial aid applications;
- Disbursing billions of dollars in aid funds to students through schools;
- Enforcing financial aid rules and regulations;
- Educating students and families on the process of obtaining aid;
- Servicing millions of student loan accounts;
- Securing repayment from borrowers who have defaulted on their loans; and
- Operating information technology systems and tools that manage billions in student aid dollars.

This is a complex, multifaceted mission that calls on a range of staff skills and demands coordination by all levels of management. Designated a Performance-Based Organization (PBO) by Congress in 1998, Federal Student Aid emphasizes tangible results and efficient performance, as well as the continuous improvement of the processes and systems that support our mission.

Federal Student Aid Organizational Structure

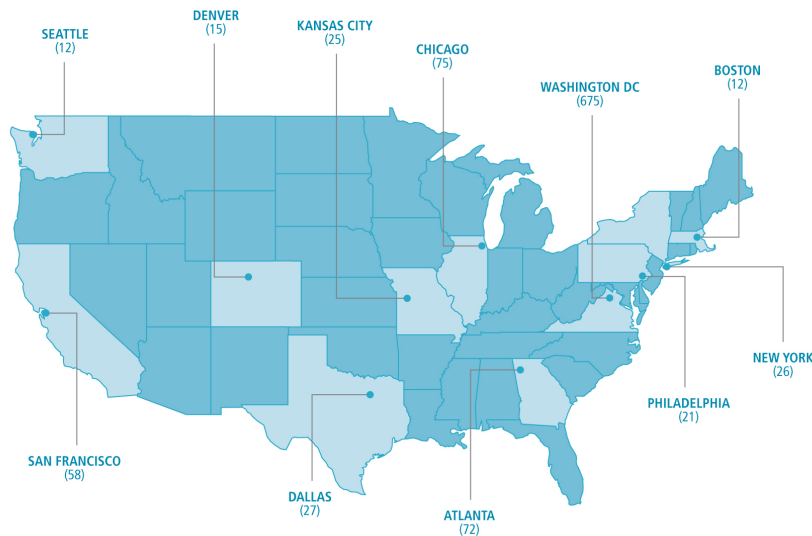
Federal Student Aid currently operates under a functional structure that aligns our organization closely with our strategic drivers, business objectives and mission goals. This structure reinforces a key business goal: efficient, effective and productive interaction with our many stakeholders. This community of stakeholders includes students and parents, schools, lenders, guaranty agencies and taxpayers, as well as other federal entities and the Department itself. The following graphic illustrates the current functional structure of Federal Student Aid.

Federal Student Aid Organizational Structure



A Chief Operating Officer (COO), who is appointed to a five-year term by the Secretary of Education, leads Federal Student Aid. Lawrence A. Warder, the Chief Financial Officer of the U.S. Department of Education, is currently the Acting COO. In fiscal year (FY) 2007, the organization operated on an annual administrative budget of approximately \$644 million. Our staff of approximately 1,000 is augmented by contractors who provide outsourced business operations. This workforce is based out of Washington, D.C., with ten regional offices located throughout the country.

Federal Student Aid Regional Map



As a federally designated PBO, Federal Student Aid operates under a congressional mandate to achieve concrete mission results as we improve efficiency in operations and manage and mitigate risks in Title IV portfolio performance. Federal Student Aid has focused on innovations for upgrading student aid delivery and servicing operations, vendor and contract management, budgeting and cost control as well as financial and operational management. Much of the resulting operational performance improvement stems from business process reengineering and large-scale technology integration.

Federal Student Aid is responsible for helping students manage the costs of education beyond high school. This duty includes administering the federal student financial assistance programs

authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended. The Title IV programs collectively represent the nation's largest source of financial aid for postsecondary students. In the paragraphs that follow, we briefly describe each of the major Title IV programs that deliver aid to students and their families.

In FY 2007, Federal Student Aid delivered or supported the delivery of approximately \$82 billion in grant, work-study and loan assistance to almost 11 million postsecondary students and their families. These students attend approximately 6,200 active institutions of postsecondary education accredited by dozens of agencies. Many of these students receive loans from approximately 3,200 lenders with 35 agencies guaranteeing those loans.

The **Federal Pell Grant (Pell Grant) Program** helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-based of the Department's student aid programs, Pell Grant awards, vary according to the financial circumstances of students and their families. For the 2006–2007 award year, the Department disbursed \$12.9 billion in Pell Grants averaging approximately \$2,492 to 5.2 million students. The maximum Pell Grant award was \$4,050 for the 2006–2007 award year. The maximum Pell Grant award increased to \$4,310 for the 2007–2008 award year. Recent legislation increased the maximum Pell Grant award to \$4,800 for the 2008–2009 award year.

The **Academic Competitiveness Grant (ACG)** and **National Science and Mathematics Access to Retain Talent (SMART) Grant Programs** were created by the Higher Education Reconciliation Act of 2005 (HERA), signed into law in 2006. The ACG is for full-time undergraduates, who are U.S. citizens and are eligible for a Pell Grant. The student must have completed a rigorous high school program, as determined by the state or local education agency and as recognized by the Secretary of Education. First-year students may receive an ACG award up to \$750, whereas second-year students may receive up to \$1,300 if they have maintained a cumulative grade point average (GPA) of at least 3.0. The ACG award became available in the 2006–2007 school year for first-year students who graduated high school after January 1, 2006, and second-year students who graduated high school after January 1, 2005. The ACG award is in addition to the student's Pell Grant award. For the 2006–2007 academic year, \$242 million in ACG awards were disbursed to approximately 310,000 students.

The National SMART Grant Program provides up to \$4,000 to third- and fourth-year undergraduates studying full-time and majoring in physical, life or computer sciences, mathematics, technology, engineering or in a foreign language critical to national security. The student must be a U.S. citizen and meet eligibility requirements for a Pell Grant. The student must maintain a cumulative GPA of at least a 3.0 for coursework required for the major. The grant award is in addition to the student's Pell Grant award. A student cannot receive more than one ACG or National SMART Grant award in each academic year for which they are eligible. For the 2006–2007 academic year, \$206 million in National SMART grants were disbursed to approximately 69,000 students.

The **Federal Supplemental Educational Opportunity Grant (FSEOG)**, the **Federal Work-Study (FWS)** and the **Federal Perkins Loan (Perkins) Programs** are three campus-based programs through which the Department provides funds directly to eligible institutions, enabling them to offer grants, employment and low-interest loans to students based on need. For the 2006–2007 award year, approximately \$3.2 billion was disbursed through approximately 2.7 million campus-based awards.

There are two **state grant** programs. The **Leveraging Educational Assistance Partnership (LEAP) Program**, authorized by Section 415A of the HEA of 1965 (as amended), makes federal funds available to assist states in providing student financial assistance programs for individuals with substantial financial need. The **Special Leveraging Educational Assistance Partnership (SLEAP) Program** was added to the LEAP Program in the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their respective LEAP programs, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement or Critical Careers Scholarships to students with substantial financial need. For the 2006-2007 academic year, approximately \$165 million in LEAP grants were disbursed to approximately 165,000 students.

The William D. Ford Federal Direct Loan (Direct Loan) Program and the Federal Family Education Loan (FFEL) Program are two major programs that account for nearly all of the remainder of the Department's financial assistance for postsecondary education. Loans made to students can either be subsidized or unsubsidized. With subsidized loans, the government pays the interest while the student is in school and during qualified periods of grace and deferment. This is not the case with unsubsidized loans, where the student borrower is responsible for paying the interest on the loan. Loans to parents of students are also available.

In fulfilling our program responsibilities, Federal Student Aid directly manages or oversees almost \$500 billion in outstanding loans—representing more than 84 million student loans to almost 29 million borrowers.

The **Direct Loan Program** lends funds directly to students and parents through participating schools. This program is funded by borrowings from the U.S. Treasury (Treasury), as well as an appropriation for subsidy costs. In FY 2007, the Department made \$12.9 billion¹ in net loans to 1.7 million recipients.

Under the **FFEL** Program, students and parents can obtain loans through private lenders. Loan guaranty agencies insure these funds, and they are, in turn, reinsured by the federal government.

During FY 2007, Federal Student Aid supported the delivery of \$51 billion² in net loans to 6.2 million FFEL recipients. In addition, Federal Student Aid made gross payments of approximately \$11 billion to lenders for interest and special allowance subsidies, and \$7.75 billion to guaranty agencies for reinsurance claims and fees paid to guaranty agencies for loan processing, issuance and account maintenance.

¹ Excludes consolidation loans of \$4.4 billion.

² Excludes consolidation loans of \$47.5 billion.

Performance Goals, Objectives and Results

Since Federal Student Aid became a PBO in 1998, we have introduced many substantial and measurable improvements in how we plan and report our operational and portfolio performance in administering the federal student financial assistance programs.

Strategic Planning and Reporting

Several key strategic drivers form the scope and content of Federal Student Aid's long-term goals and objectives:

- HEA Legislation;
- Federal Financial Management Laws and Regulations;
- Customer Needs;
- PBO Legislation;
- The Department's Strategic Plan;
- The President's Management Agenda (PMA); and
- The Department's Management Challenges.

The foundation of our long-term strategic planning is Federal Student Aid's five core strategic objectives. Taken collectively, these objectives provide the framework for continuous improvement at Federal Student Aid, guiding us in managing our programs more effectively and providing clear strategic direction to all of Federal Student Aid's internal and external constituencies.

Our core strategic objectives are to:

- Integrate Federal Student Aid systems and provide new technology solutions;
- Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement;
- Reduce program administration costs;
- Improve human capital management; and
- Improve products and services to provide better customer service.

Federal Student Aid's long-term planning is outlined in its Five-Year Plan, a statement of strategic direction providing long-term guidance. Beginning with the FY 2006 – FY 2010 Five-Year Plan, Federal Student Aid has established and documented strategic performance standards to measure the organization's success in meeting the stated long-term objectives.

While the Five-Year Plan outlines our strategic direction and provides long-term guidance in achieving organizational objectives, Federal Student Aid requires each business unit to annually develop a business plan that clearly articulates specific business goals over the ensuing three fiscal years. The business plan is fully aligned with the Five-Year Plan, bridging the gap between long-term, strategic organizational planning and annual, tactical business-level scheduling and implementation.

Tactical Performance Planning and Reporting

Federal Student Aid's Annual Performance Plan establishes specific tactical initiatives to achieve both business unit goals outlined in the business plans and organizational strategic objectives outlined in the Five-Year Plan. Timelines, milestones and status are maintained in the Annual Performance Plan and evaluated on a monthly basis to ensure their alignment with current business needs, the allocation of resources, the availability and allocation of capital and operating funds, policy considerations, and statutory and regulatory requirements.

The Annual Report provides the mechanism for reporting the organization's annual tactical performance results, including the organization's audited financial statements and the organization's progress in meeting tactical goals established in the Annual Performance Plan. These documents—the Five-Year Plan, the Annual Performance Plan and the Annual Report—form the foundation of Federal Student Aid's strategic planning, tactical implementation and reporting processes.

Performance Management

Federal Student Aid's performance management is a critical component in our strategic vision, as well as our day-to-day operations. Our performance management initiatives are wide-ranging and influence every aspect of our business. As a result, Federal Student Aid has developed a range of tools to monitor and report on organizational performance on a weekly, monthly and annual basis. Refer to the "Tactical Performance Planning and Reporting" section for discussion of annual performance planning and reporting.

Performance management includes weekly and monthly project planning and reporting activities detailing the scope, schedule, cost, quality and overall status of key initiatives. Federal Student Aid's budget management process and our unit-cost model provide cost identification, control and management. Federal Student Aid also continually tracks and reports enterprise-wide operational, human capital and performance metrics through a series of dashboard reports.

The elements below highlight several enterprise performance planning and reporting programs and practices.

Program and Business Operations

In addition to annual planning and reporting, Federal Student Aid's performance management is supported year-round by various teams throughout the enterprise that help us to meet our five core objectives. The groups described below each play an integral part in ensuring Federal Student Aid performs efficiently.

- **Investment Management Committee (IMC)**

Federal Student Aid's IMC provides a rigorous review process for major and significant Federal Student Aid initiatives. The IMC ensures that Federal Student Aid reviews investments appropriately, maintains information technology compliance with the Clinger-Cohen Act and aligns all its initiatives with Federal Student Aid's Performance Plan and the Department's Strategic Plan.

Through the IMC, Federal Student Aid manages initiatives from an enterprise perspective, encourages partnerships and eliminates duplicative and stove-piped projects while balancing benefits against the costs and risks of each initiative. Once an initiative is approved by the IMC, it is monitored through the Project Management Office and its status is reported regularly to the IMC members.

- **Project Management Office**

The Project Management Office, established in FY 2003, is the central point of oversight for all projects. Through the Project Management Office, we integrate all project activities within Federal Student Aid, linking them to strategic objectives, priorities and available resources. It supports project managers by establishing enterprise project management standards of practice, advising on systems integration strategy, sharing information across projects during the full life cycle of the projects and providing relevant reports and data to management.

Key Performance Goals and Results

This section provides a high-level overview of Federal Student Aid's FY 2007 performance objectives and results. The information provides a summary of our achievements and our progress in meeting the organization's stated performance standards. See the Annual Program Performance Report section of this report for additional information regarding our accomplishments and Federal Student Aid's FY 2007 Annual Performance Plan for specific details regarding the organization's progress in meeting each Performance Plan tactical goal.

The table below summarizes Federal Student Aid's performance results for FY 2007 performance objectives. There are 27 key measures, two of which were discontinued in FY 2007, that support the mission and strategic goals. During FY 2007, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the Five-Year Plan. For the most recent data available, Federal Student Aid has met targets for 21 key measures, did not meet targets for three measures, continues to analyze the impact of portfolio performance on the Cumulative Lifetime Default Rate (CLTDR) before identifying future performance targets as noted below and discontinued two measures. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid. More information is provided in the Annual Program Performance Report section of this report.

Shown below are the actual results for each key measure. The table presents whether the actual result met or failed to meet the target. In some cases, establishing a baseline is the target and is recognized as met if the data are available and the baseline is established. Note: Performance standards were established in the FY 2006-2010 Five-Year Plan. As a result, historical data may not be available for some of the indicated standards because the Department did not collect the data prior to FY 2006.

Note that for Objective 1, while the objectives of ADvance, Common Services for Borrowers and Information Framework remain the same, the development and procurement strategies to achieve them will change. As a result, FY 2007 Performance Standards were updated to reflect Federal Student Aid's new development and procurement strategies. In the Annual Program Performance section of this report, we report Federal Student Aid progress against both the original standards and the new standards. In future updates, we will report against the new FY 2007 standards.

Legend	PM = Performance measured, standards and/or targets not established
NA = No measure for period	Met = Met or exceeded target
T = Measure replaced or discontinued	Not Met = Target not met

Performance Results Summary	FY 2005	FY 2006	FY 2007
Strategic Objective 1—Integrate Federal Student Aid Systems and provide new technology solutions.			
1.1 - Common Services for Borrowers			
A. Timely completion of all scheduled deliverables	PM	Not met	T
1.2 - ADvance			
A. Timely completion of all scheduled deliverables	PM	Not met	T
1.3 - Integrated Partner Management			
A. Timely completion of all scheduled deliverables	NA	Met	Met
1.4 - Information Framework/Infrastructure			
A. Timely completion of all scheduled deliverables	NA	Met	Met
1.5 - Integrate Aid Delivery Systems			
A. Completion of development and contracting strategy	NA	NA	Met
1.6 - Acquisition Strategy			
A. Finalize approach and timeline for IT developer pool	NA	NA	Met
1.7 - Infrastructure			
A. Complete Phase I of Virtual Data Center (VDC) transition (Due Diligence)	NA	NA	Met
Strategic Objective 2—Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.			
2.1 - PMA Score			
A. Financial Management	NA	Met	Met
B. Improper Payments	NA	Met	Met
2.2 - Cumulative Lifetime Default Rate—Title IV Student Loan Portfolio			
	NA	Met	PM*
2.3 - National Cohort Default Rate (CDR)			
	PM	Met	Met
2.4 - Direct Loan Default Recovery Rate			
	PM	Met	Met
2.5 - FFEL Default Recovery Rate			
	PM	Met	Met
Strategic Objective 3—Reduce program administration costs.			
3.1 - Reduce the Unit Cost to Process an Electronic Free Application for Federal Student Aid (FAFSA)			
	NA	Met	Met
3.2 - Reduce the Unit Cost of Originating and Disbursing Direct Loans and Pell Grants			
	NA	Met	Met
3.3 - Reduce the Unit Cost of Servicing a Direct Loan Borrower			
	NA	Met	Not Met
3.4 - Reduce the Unit Cost of Collecting One Dollar in Default Status			
	NA	Met	Met

*The CLTDR was first published in FY 2006. Since that time, Federal Student Aid has produced and published the FY 2005, FY 2006 and FY 2007 calculations for the relevant preceding five year periods, respectively. Federal Student Aid will continue to analyze the impact of portfolio performance on the CLTDR before identifying future performance targets.

Performance Results Summary	FY 2005	FY 2006	FY 2007
Strategic Objective 4—Improve human capital management.			
4.1 - Leadership Training	NA	Met	Met
4.2 - Acquisitions Training	NA	Met	Met
4.3 - Project Management Training	NA	Met	Not Met
4.4 - Federal Student Aid Training			
A. Federal Student Aid Business Knowledge Training	NA	Met	Met
B. School Compliance Officials Training	NA	Met	Met
C. General Workforce Training	NA	Met	Met
Strategic Objective 5—Improve products and services to provide better customer service.			
5.1 - Student Aid Application	PM	Not Met	Not Met
5.2 - School Origination and Disbursement	PM	Met	Met
5.3 - Lender Payment Processing	PM	Not Met	Met
5.4 - Direct Loan Borrower Servicing	PM	Met	Met

During FY 2007, Federal Student Aid made progress in meeting our performance standards as outlined in the Five-Year Plan. For the five objectives summarized below, please refer to the Annual Program Performance Section where the corresponding Performance Standard as well as the organization’s progress in meeting the stated target has been identified.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.

Federal Student Aid improved efficiency and productivity, reduced systems’ maintenance and overhead costs and increased the operating ease for users of our systems. Federal Student Aid continues to provide appropriate and integrated technology solutions that enable ongoing improvements for a more efficient and cost-effective delivery and administration of the federal student financial assistance programs. In addition, the organization will take advantage of new technologies to improve application processing, customer service, productivity and efficiency.

In FY 2007, Federal Student Aid continued to pursue system and business process integration measures to lower costs while improving program integrity and system security as well as the quality and accessibility of our products and services. The pursuit of lower costs did not come at the expense of customer service, as we continued to provide the world-class customer service that has consistently placed Federal Student Aid in the top tier of industry rankings for customer satisfaction. As we pursue integration initiatives, we have continuously reevaluated existing strategies, as necessary, and explored new and innovative approaches and technology to help us achieve our goals. In FY 2007 we successfully:

- Reprioritized several major initiatives on Federal Student Aid’s sequencing plan related to integration of the aid delivery process and systems.
- Ranked in the highest six of all government agencies in the Office of Management and Budget (OMB) Enterprise Architecture assessments.

- Improved the security of Personally Identifiable Information (PII) by: migrating certain data transfers previously done via unsecured tape transfers to encrypted electronic file transfers, implementing laptop encryption for Program Compliance personnel and implementing new PII policies and procedures.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.

Federal Student Aid ensured that student aid under the Title IV programs is delivered directly by Federal Student Aid and through school, lender and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, abuse and mismanagement. Federal Student Aid is continually working to improve program integrity and is committed to continued success in the management of the Title IV programs. In FY 2007, Federal Student Aid successfully:

- Achieved a continued low rate of 4.6% for the FY 2005 CDR.
- Processed over 95% of school compliance audits within 180 days of receipt, enhancing school program monitoring and oversight.
- Established the Inducement Workgroup to review complaints, inquiries and suspected program violations related to improper inducements in the Federal Family Education Loan Program.
- Strengthened National Student Loan Data System (NSLDS) access policies, security measures and usage practices for authorized users.

Objective 3: Reduce program administration costs.

Federal Student Aid reduced the cost of administering the Title IV programs through strong financial, operational and budget management; the reengineering of overly complex business processes; and simplification of the business application and computing environment to reduce system complexity, minimize integration challenges, align contracts and reduce vendor management. Our aim is to improve the exchange of data with program participants and across the Federal Student Aid enterprise. In recent years, Federal Student Aid has maintained a relatively flat operating budget, while supporting continued increases in program volume and workload. Federal Student Aid's ability to manage and control operating expenses is based on a philosophy of good fiscal management and continuous process improvement practices that increase productivity and operational efficiencies as well as innovation in our products, services and supporting technologies. In FY 2007, Federal Student Aid successfully:

- Continued to expand the Activity-Based Costing (ABC) Model to facilitate reduction of administrative costs, identify process improvement opportunities and assist in budget formulation.
- Renegotiated the Common Services for Borrowers contract resulting in future savings.
- Significantly increased small-business participation in Federal Student Aid procurement through better internal controls, communications and management emphasis and support.

Objective 4: Improve human capital management.

Human capital management is a critical component of Federal Student Aid's current business operations and future initiatives. Federal Student Aid continues to grow as an organization that empowers individuals to perform at a high level of effectiveness and efficiency. Federal Student Aid utilized innovative hiring and employee development techniques aimed at attracting and retaining highly qualified individuals to create a more productive, results-oriented workforce. Additionally, the organization is committed to workforce development and training to ensure a skilled and highly qualified professional workforce. In FY 2007, Federal Student Aid successfully:

- Developed and executed an organization-wide training plan supporting enterprise skills development in areas such as critical thinking, project management, policy and procedure development, statistical analysis, technical writing, and time management.
- Achieved an overall score of 90 (out of 100) on Office of Personnel Management's (OPM) Performance Appraisal Assessment Tool for employee performance management practices. This is within the highest range possible and establishes Federal Student Aid as a model organization for our employee performance management practices.
- Completed rollout of the Electronic Official Personnel Folder to all Federal Student Aid employees.
- Launched *Student Aid Front2Back*, an on-line course that provides an overview of the student aid process.

Objective 5: Improve products and services to provide better customer service.

Federal Student Aid continues to improve products and services to students and their families and program participants such as schools, lenders and guaranty agencies. Being aware of the concerns of customers is a critical component of our efforts to improve federal student aid products and services. Federal Student Aid continues to reduce the complexity of our products and services, ensuring that compliance is maintained, while providing customers with 24 hour-a-day access and promoting increased self-service opportunities for customers. In addition, Federal Student Aid continues to develop strategies to provide integrated solutions for customers. In FY 2007, Federal Student Aid successfully:

- Scored in the "Excellent" and "Good" range in the FY 2007 American Customer Satisfaction Index (ACSI) ratings for Federal Student Aid's highest volume products and services – including Direct Loan Servicing, FAFSA on the Web, the Common Origination and Disbursement system (COD) and the Lender Reporting System (LaRS).
- Launched a Federal Student Aid Public Service Campaign resulting in over 30,000 television airings generating over 500 million impressions worth an estimated \$13.3 million and over 90,000 radio airings generating over 250 million impressions worth almost \$12 million.
- Developed and launched the FAFSA4caster providing college-bound students and their families with an early estimation of financial aid eligibility prior to their senior year in high school.

Performance Reporting Limitations and Difficulties

The underlying assumptions in Federal Student Aid's performance planning and reporting processes are based on current budgetary, operational, and policy considerations. External events beyond our control can impact these underlying assumptions, potentially impacting the organization's ability to plan, meet and report upon its objectives. As necessary, Federal Student Aid reevaluates and revises its performance planning and reporting processes to adapt to these external factors.

Data Quality of Performance Information

Effective decision making requires complete, accurate, timely and reliable data. Funding decisions are made and management actions are taken based on performance information. Reliable information is a prerequisite for effective management. In addition to performance data received from our FFEL program participants, we deal with financial data. Our data-quality processes for financial data are reflected in our financial statements and accompanying notes.

Federal Student Aid develops and uses such data for various purposes. One of the most visible areas in which this occurs is the annual budget-development process. The central focus of our budget process is to align goals, objectives, performance measures and program funding levels to develop a performance budget. One of the five government-wide elements of the PMA is the integration of budget and performance, which focuses on making budget decisions based on results.

Federal Student Aid, facing opportunities provided by the integrated performance-based budget process and activity-based management, recognizes the need to improve the accuracy, reliability and completeness of our data. Although immediate connections between specific performance and funding levels are sometimes challenging to make, Federal Student Aid is improving systems to yield reliable performance data to make informed budget and policy decisions. These systems will enhance our budget process and increase the accuracy and reliability of the information we receive from our FFEL program participants.

Federal Student Aid is engaged in a long-term effort to improve data quality by integrating its processes, data and systems. In 2007, Federal Student Aid formally established an Enterprise Data Management (EDM) program to better support business objectives and to emphasize data as an enterprise asset. The goal of the EDM program is to consistently define data and make standardized data available across the enterprise by providing information services and data technology expertise to business owners, project managers and architects.

In an effort to improve the data standards in the community:

- Federal Student Aid has partnered with the Postsecondary Electronics Standards Council which is a non-profit, community-based, umbrella association of colleges and universities; professional and commercial organizations; data, software and service providers; and state and federal government agencies to assist in data standardization across the education community.
- Federal Student Aid has also worked collaboratively with the National Center for Educational Statistics as it began development of a new system interface for its Integrated Postsecondary Education Data System (IPEDS). This collaboration effort will result in a standardized schema and facilitate reporting efforts by colleges and universities.
- Finally, Federal Student Aid has worked collaboratively with the Office of Planning, Evaluation and Policy development to encourage alignment of data standardization efforts between K-12 and Postsecondary organizations.

Analysis of Federal Student Aid's Financial Statements

Federal Student Aid is committed to providing sound management, financial systems and controls to ensure that students receive aid and repay loans according to applicable laws and regulations. Federal Student Aid's financial statements are prepared in accordance with established federal accounting standards and are audited by the independent accounting firm.

For the sixth consecutive year, Federal Student Aid achieved an unqualified audit opinion on its financial statements. The Report on Internal Control cited no material weaknesses in internal controls.

For fiscal years 2007 and 2006, the Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position were prepared on a consolidated basis, and the Statement of Budgetary Resources was prepared on a combined basis as required by OMB Circular A-136, Financial Reporting Requirements. For FY 2007, the Statement of Financing is no longer required as a separate financial statement under OMB Circular A-136, Financial Reporting Requirements and the Statement is replaced by a separate footnote disclosure, Note 14. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

For the FFEL and Direct Loan programs, appropriations are available to cover the subsidy cost of each program, as well as administrative expenses. Subsidy expense covers the difference between the net present value of expected future cash flows and the face value of the loan portfolio. Appropriation authority is available as needed on a permanent basis to finance costs resulting from loans guaranteed in the years before FY 1992. The Pell Grant program receives appropriations to cover actual grant disbursements.

A comparison between significant line items reported in Federal Student Aid's FY 2007 and 2006 financial statements is presented in the following table. The percentage change for Net Cost of Operations is primarily the result of decreases in FFEL and Direct Loan costs as explained in the Statement of Net Cost section.

Summarized Financial Data as of September 30, 2007 and 2006 (Dollars in Millions)				
	Percentage Change	Dollar Difference	Fiscal Year 2007	Fiscal Year 2006
Total Assets	0.3%	\$ 495	\$175,066	\$174,571
Total Liabilities	- 1.7%	(\$ 2,864)	\$163,220	\$166,084
Net Position	39.6%	\$ 3,359	\$ 11,846	\$ 8,487
Net Cost of Operations	-61.8%	(\$31,523)	\$ 19,508	\$ 51,031

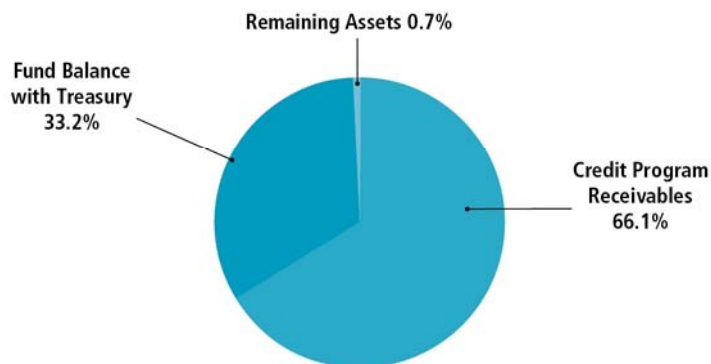
**The Balance Sheet
Composition of Federal Student Aid Assets**

The Consolidated Balance Sheet shows Federal Student Aid with total assets of \$175.1 billion as of September 30, 2007. This represents an increase of \$0.5 billion over the previous year's total assets of \$174.6 billion as of September 30, 2006. The difference resulted primarily from the combined impact of increases in Credit Program Receivables, and decreases in Fund Balance with Treasury for FFEL and Direct Loans.

Fund Balance with Treasury represents Federal Student Aid's funds available to make authorized expenditures and finance loan programs. It decreased by \$9.4 billion between FY 2006 and FY 2007, primarily due to reduced loan consolidation volume and resulting decrease in new direct loan disbursements that require Fund Balance on hand. The Treasury processes Federal Student Aid's cash receipts, such as appropriation warrants, that provide cash for operations and loan payment collections received from students. The Treasury also processes operating expenditures and other disbursements on behalf of Federal Student Aid.

Credit Program Receivables, net of subsidy allowance, increased by \$9.4 billion during FY 2007. 85.5 percent of Federal Student Aid's \$115.8 billion loan portfolio is principal and interest owed by students on Direct Loans. The remaining 14.5 percent is defaulted guaranteed loans purchased from lenders under the terms of the FFEL Program and Perkins Program. Direct loan net portfolio increased by \$6.4 billion in FY 2007 and FFEL net loans were up \$3.0 billion over FY 2006. Direct loan disbursements exceeded loan collections, primarily because collections from loan consolidations were greatly reduced in FY 2007 compared to FY 2006. FFEL payments for defaulted loans exceeded loan collections, also due to lesser amounts of guaranteed loans collected by consolidation in FY 2007 compared to FY 2006.

Composition of Federal Student Aid Assets as of September 30, 2007

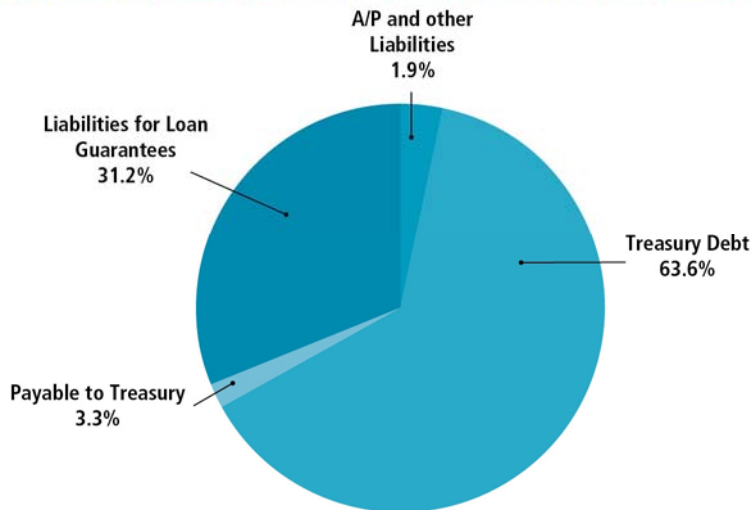


Composition of Federal Student Aid Liabilities

Federal Student Aid had total liabilities of \$163.2 billion at September 30, 2007. Of this amount, \$103.9 billion is the balance due to Treasury for borrowing to disburse direct student loans. Federal Student Aid funds its direct loans with the appropriation for subsidy costs and borrowings from Treasury.

Total liabilities decreased \$2.9 billion during FY 2007. Debt due to Treasury for the Direct Loan program decreased \$1.5 billion, due to the decreased volume of direct loan disbursements compared to FY 2006. The FFEL liabilities for Loan Guarantees decreased \$1.6 billion. A decreased volume of loan consolidations results in a decrease in liability for Federal Student Aid. The liabilities present the estimated costs, on a present-value basis, of the net long-term cash outflows due to loan defaults net of offsetting fees. Loan guarantees encourage private lenders to provide student loans.

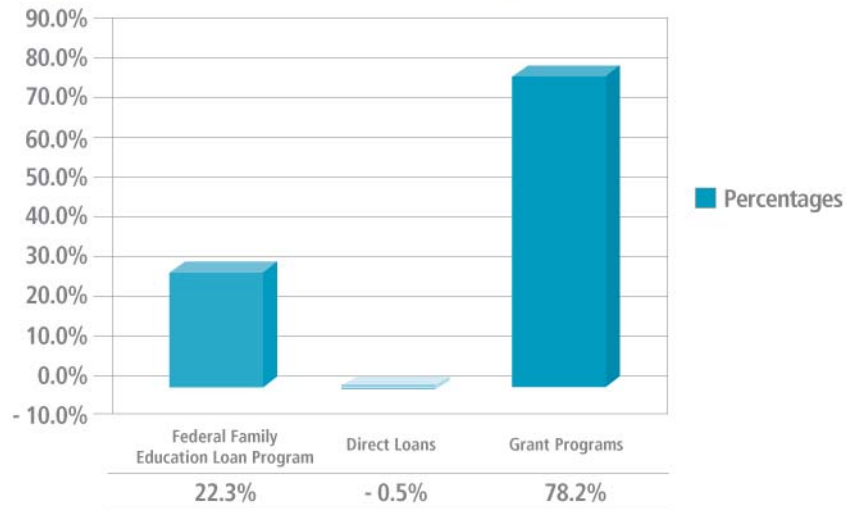
Composition of Federal Student Aid Liabilities as of September 30, 2007



Statement of Net Cost

Federal Student Aid's net cost for FY 2007 was \$19.5 billion, a decrease of \$31.5 billion from FY 2006. FFEL program net costs of \$4.3 billion in FY 2007 decreased from \$28.4 billion in FY 2006. This was due to lesser subsidy costs both as calculated for all FFEL programs and in volume due to decreased loan consolidations. The Direct Loan program recorded a \$7.1 billion decrease in net costs over FY 2006, again due to both lesser subsidy costs overall and a lesser volume of direct loan disbursements over previous years. Grant program costs remained stable at \$15.3 billion in FY 2007, a small decrease from \$15.6 billion in FY 2006.

Composition of Federal Student Aid Net Costs as of September 30, 2007



Statement of Changes in Net Position

Federal Student Aid's Net Position as of September 30, 2007 was \$11.8 billion, a \$3.3 billion increase over the \$8.5 billion Net Position as of September 30, 2006. A lesser amount of unfunded accrued liabilities at the end of FY 2007 over FY 2006, coupled with a slight increase in unexpended appropriations, made up the increase.

Statement of Budgetary Resources

The Statement of Budgetary Resources compares the budgetary resources provided with the status or execution of those resources and provides details about the composition of resources, their status, and net outlays. Federal Student Aid had \$121.7 billion in combined budgetary resources, of which \$38.4 billion remains unobligated and not available at year end.

Federal Student Aid's total net outlays for FY 2007 were \$30.3 billion, an increase of \$5.2 billion over FY 2006. Although gross outlays for Federal Student Aid decreased due to lower loan consolidation and origination activity in FY 2007, the amount of offsetting collections also decreased significantly. The decrease in offsetting collections was due to lower collections from loan consolidations that are recorded as loan prepayments when consolidated and disbursed.

Analysis of Federal Student Aid's Systems, Controls and Legal Compliance

Internal control is a major part of managing an organization. It comprises the plans, methods and procedures used to meet missions, goals and objectives and, in doing so, supports performance-based management. Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. In short, internal control, which is synonymous with management control, helps government program managers achieve desired results through effective stewardship of public resources.

Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories:

- Effectiveness and efficiency of operations, including the use of the entity's resources.
- Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use.
- Compliance with applicable laws and regulations.³

Federal Student Aid management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of Federal Managers' Financial Integrity Act (FMFIA). Federal Student Aid conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, Management's Responsibility for Internal Control. Based on the results of this evaluation, Federal Student Aid reported to the Department's management that its internal controls over the effectiveness and efficiency of its operations and compliance with applicable laws and regulations, as of September 30, 2007, were operating effectively, except for the material weakness described in the table below and disclosed in the Department's FY 2007 Performance and Accountability Report related to Federal Student Aid's operations and/or compliance.

³ Government Accountability Office (GAO) Standards for Internal Control in the Federal Government, GAO/AIMD-00-21.3.1, November 1999, p. 4-5

Material Weakness	Description	Corrective Action	Anticipated Correction Date
Monitoring and Oversight of Guaranty Agencies, Lenders and Servicers	Financial Partner Eligibility & Oversight had internal control deficiencies related to monitoring and oversight of Guaranty Agencies, Lenders and Servicers that aggregate to a material weakness.	<p>To address the internal control deficiencies, Federal Student Aid has re-evaluated its overall approach to oversight and monitoring of financial institutions, resulting in numerous corrective actions. The more significant corrective actions include the following:</p> <ol style="list-style-type: none"> 1) Clear delineation of functional responsibility within Federal Student Aid for oversight of these entities. 2) Development and full implementation of a more rigorous risk assessment methodology that will identify high-risk areas. This risk assessment methodology includes specific steps to incorporate recommendations from audits and reviews performed by organizations external to Federal Student Aid. 3) Standardization of the program review process to ensure consistency in decisionmaking. 4) Enforcement of appropriate corrective actions and the measurement of effectiveness of actions <p>Together, these corrective actions and numerous others form a broader plan to provide the necessary oversight and monitoring to ensure compliance with the HEA, regulations, and guidance.</p>	Corrective Action Plans have been submitted for all audit findings and will be implemented by December 31, 2008.

In addition, Federal Student Aid, working with the Department's management, conducted its current year assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123, Management's Responsibility for Internal Control. The scope of Federal Student Aid's assessment included the following processes that impact the Department's financial statements:

- Direct Loan originations and disbursements;
- Direct Loan servicing;
- Direct Loan consolidations;
- Debt management;
- Grants disbursements (Pell, Campus-based, ACG, and SMART);
- Financial partner invoicing and oversight;
- Determining student and institutional eligibility;
- Procurement management (contract acquisition, receipt of goods/services and invoicing);
- Financial closing and reporting (month-end and year-end closing, journal voucher processing, analytical procedures, and reconciliations); and
- General computer controls related to various agency systems.

Based on the results of this evaluation, Federal Student Aid provided reasonable assurance to the Department's management that its internal control over financial reporting as of June 30, 2007 was operating effectively and no material weaknesses were found in the design or operation of the internal control over financial reporting.

In participating in the Department's successful implementation of OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A requirements, Federal Student Aid continues to build upon its internal control framework that will be used in continuing efforts to monitor and improve internal controls.

Please refer to the Department's Performance and Accountability Report (PAR) for information related to the Department's compliance with the Federal Financial Management Improvement Act.

Improper Payment Information Act (IPIA) Reporting

The IPIA of 2002 requires agencies to annually review all programs and activities to identify those susceptible to significant improper payments. The guidance 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 the annual amount of estimated improper payments, along with steps taken and actions planned to reduce them. OMB uses quarterly color-coded scorecards to monitor agencies' status and progress toward attaining the PMA program initiative goals. In conjunction with the requirements of the IPIA, a relatively new key initiative, entitled "Eliminating Improper Payments", summarizes the results of quarterly actions to ensure compliance with the IPIA. Federal Student Aid achieved a "green" progress score and "yellow" status score on the September 30, 2007, PMA scorecard for Eliminating Improper Payments.

Federal Student Aid measures and reports annual improper payment estimates for the Pell Grant and FFEL Programs. OMB automatically considers programs previously required to report under OMB Circular A-11, Preparation, Submission and Execution of the Budget, Section 57, Information on Erroneous Payments, as susceptible to significant improper payments, regardless of the established thresholds. Risk assessments conducted in FY 2007 indicated that other programs administered by Federal Student Aid are not at significant risk of improper payments. For more detail, please refer to the Department's PAR.

Possible Future Effects of Existing Events and Conditions

Federal Student Aid's ability to fully implement the initiatives described in this report is impacted by external factors, including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and OMB to develop our administrative budget and ensure appropriate resources are allocated to support our strategic objectives. Legislative and/or regulatory action may result in policy, resources or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the HEA is scheduled to occur during this session of Congress, and Federal Student Aid will revise both our Annual Performance Plan and the Five-Year Plan to meet the new legislative and/or regulatory requirements. Other external factors could also affect our ability to achieve the organization's objectives. For example, in August and September 2005, hurricanes Katrina and Rita caused extensive damage to Gulf Coast Region of the United States. As a result, Federal Student Aid mounted a large-scale response effort to assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita. We are unable to anticipate the full cost or impact to Federal Student Aid's strategic objectives as a result of our long-term commitment to other similar unforeseen events.

Limitations of Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

ANNUAL PROGRAM PERFORMANCE REPORT

Annual Program Performance

During FY 2007, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the Five-Year Plan. The information presented herein provides details of our achievements, by objective. Under each objective below, we have identified the corresponding Performance Standard, as well as the organization's progress in meeting the stated target. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid. Additional information is provided in the Management's Discussion and Analysis, Performance section of this report.

Key Performance Goals and Results

This section provides a high-level overview of Federal Student Aid's FY 2007 performance objectives and results. The information presented below provides a summary of our achievements and our progress in meeting the organization's stated performance standards. See Federal Student Aid's FY 2007 Annual Performance Plan for specific details regarding the organization's progress in meeting each Performance Plan tactical goal. During FY 2007, Federal Student Aid made significant accomplishments, as well as progress in meeting our performance standards as outlined in the Five-Year Plan. Under each objective below, we have identified the corresponding Performance Standard as well as the organization's progress in meeting the stated target. Unless otherwise noted, these performance standards and their respective ratings are based on criteria established by Federal Student Aid.

Objective 1: Integrate Federal Student Aid systems and provide new technology solutions.

Federal Student Aid improved efficiency and productivity, reduced systems' maintenance and overhead costs and increased the operating ease for users of our systems. Federal Student Aid continues to provide appropriate and integrated technology solutions that enable ongoing improvements for a more efficient and cost-effective delivery and administration of the federal student financial assistance programs. In addition, the organization will take advantage of new technologies to improve application processing, customer service, productivity and efficiency.

In FY 2007, Federal Student Aid continued to pursue system and business process integration measures to lower costs while improving program integrity and system security as well as the quality and accessibility of our products and services. The pursuit of lower costs did not come at the expense of customer service, as we continued to provide the world-class customer service that has consistently placed Federal Student Aid in the top tier of industry rankings for customer satisfaction. As we pursue integration initiatives, we have continuously reevaluated existing strategies, as necessary, and explored new and innovative approaches and technology to help us achieve our goals.

Specifically, some approaches, such as the ADvance and Common Services for Borrowers projects, have provided valuable insight regarding what does and does not facilitate integration. In FY 2007, ADvance and Common Services for Borrowers were recast with different development and contracting strategies that will allow Federal Student Aid to incrementally enable functions with new technology rather than perform only large-scale system replacements. Federal Student Aid continued to make progress on our multi-year sequencing plan by focusing on major initiatives and activities that bring us closer to our Target State Vision, such as the VDC transition, the development of core technology enablers such as the enterprise portal and the implementation of the Integrated Partner Management solution.

In addition, in FY 2007 we successfully:

- Reprioritized several major initiatives on Federal Student Aid's sequencing plan related to integration of the aid delivery process and systems.
- Redefined development and procurement strategies for ADvance, Common Services for Borrowers and Student Aid History Management.
- Integrated two new systems into the security architecture infrastructure.
- Implemented a technical proof of concept for the enterprise portal and began implementation with the award of the development contract for the infrastructure build and employee view.
- Ranked in the highest six of all government agencies in the OMB Enterprise Architecture assessments.
- Improved the security of PII by: migrating certain data transfers previously done via unsecured tape transfers to encrypted electronic file transfers, implementing laptop encryption for Program Compliance personnel and implementing new PII policies and procedures.

Performance Standards and Results

The following performance standards were established to measure our success in achieving our key integration initiatives. Success is predicated on the timely completion of all scheduled project deliverables in the design, development and implementation phases of the four main systems integration initiatives as described below.

Metric	FY 2004	FY 2005	FY 2006	FY 2007 (Target)	FY 2007 (Actual)	Performance
Common Services for Borrowers**	*	*	Design	Implementation	N/A	Target Not Met
ADvance**	*	*	Design	In Development	N/A	Target Not Met
Integrated Partner Management	*	*	Design	In Development	In Development	Target Met
Information Framework/ Infrastructure**	*	*	Design	Design	Design	Target Met
Integrate Aid Delivery Systems	*	*	*	Complete Development & Contracting Strategy	Strategies Completed	Target Met
Acquisition Strategy	*	*	*	Finalize Approach & Timeline for IT Developer Pool	Approach and Timeline Completed	Target Met
Infrastructure	*	*	*	Complete Phase I of VDC Transition (Due Diligence)	Phase I Completed	Target Met

* Data is not available because either 1) the Department was not collecting this data during the fiscal year indicated, 2) the project did not exist or 3) the performance standard had not yet been established.

** While the objectives of ADvance, Common Services for Borrowers and Information Framework remain the same, the development and procurement strategies to achieve them will change. As a result, FY 2007 Performance Standards were updated to reflect Federal Student Aid's new development and procurement strategies. In this report, we report Federal Student Aid's progress against both the original standards identified in the FY 2006-2010 Five-Year Plan and the new standards identified in the FY 2007-2011 Five-Year Plan. In future updates, we will report against the new FY 2007 standards.

Objective 2: Improve program integrity to facilitate access to postsecondary education, while reducing vulnerability of the federal student financial assistance programs to fraud, waste, abuse and mismanagement.

Federal Student Aid will ensure that student aid under the Title IV programs is delivered directly by Federal Student Aid and through school, lender and guarantor participants in a manner that reduces the vulnerability of these programs to fraud, waste, abuse and mismanagement. Federal Student Aid is continually working to improve program integrity and is committed to continued success in the management of the Title IV programs. In FY 2007, we successfully:

- Achieved a “green” progress score on the September 30, 2007 PMA scorecards for Financial Management, Eliminating Improper Payments and Credit Management. Achieved status scores of “green” for Financial Management, “yellow” for Eliminating Improper Payments and “red” for Credit Management also as of September 30, 2007.
- Developed and published the second iteration of the CLDTR for the Title IV student loan portfolio.
- Achieved a continued low rate of 4.6% for the FY 2005 CDR.

- Achieved FY Direct Loan and FFEL default recovery goals for FY 2007.
- Achieved unqualified financial statement audit opinion for FY 2007 for the sixth consecutive year.
- Processed over 95% of school compliance audits within 180 days of receipt, enhancing school program monitoring and oversight.
- Established the Inducement Workgroup to review complaints, inquiries and suspected program violations related to improper inducements in the FFEL Program.
- Tested new review strategy for strengthening oversight of publicly traded schools.
- Strengthened NSLDS access policies, security measures and usage practices for authorized users.
- Provided a rolling delinquency analysis to access patterns of performance or non-performance of delinquent loans in the Direct Loan program.
- Continued to conform to OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A to demonstrate sound financial management controls. In addition to complying with OMB requirements, Federal Student Aid has established an internal control framework to be leveraged for continuous internal control improvement.

Performance Standards and Results

The following performance standards were established to gauge our success in improving program integrity, while reducing the vulnerability of the Title IV programs to fraud, waste and abuse. Our success relies on maintaining “green” status on the PMA, continuing to achieve low default rates and increasing the recovery rate.

Metric	FY 2004	FY 2005	FY 2006	FY 2007 (Target)	FY 2007** (Actual)	Performance
PMA Status Score for Financial Management***	Green	Green	Green	Green	Green	Target Met
PMA Score for Improper Payments	*	Red	Yellow	Yellow	Yellow	Target Met
Cumulative Lifetime Default Rate: Title IV Student Loan Portfolio		FY 2003 5.48%	FY 2004 5.9%	NA****	FY 2005 5.5%	NA****
		FY 2002 7.82%	FY 2003 7.3%		FY 2004 8.0%	
		FY 2001 9.93%	FY2002 9.2%		FY 2003 8.8%	
		FY 2000 11.82%	FY2001 10.9%		FY 2002 10.3%	
		FY 1999 12.24%	FY 2000 12.7%		FY 2001 11.9%	
CDR	FY 2002 5.20%	FY 2003 4.50%	FY 2004 5.10%	FY 2005 <6.00%	FY 2005 4.60%	Target Met
Direct Loan Default Recovery Rate	*	*	19.0%	19.75%	20.08%	Target Met
FFEL Default Recovery Rate	*	*	19.4%	19.5%	19.61%	Target Met

* Data is not available because either 1) the Department was not collecting this data during the fiscal year indicated, 2) the project/metric did not exist or 3) the performance standard had not yet been established.

**Indicates what year the data was reported. For example, during FY 2007, Federal Student Aid calculated the FY 2005 CDR.

***See www.results.gov for definitions, trend and PMA scorecard support for both financial management and improper payments.

****The CLTDR was first published in FY 2006. Since that time, Federal Student Aid has produced and published the FY 2005, FY 2006 and FY 2007 calculations for the relevant preceding five year periods, respectively. Federal Student Aid will continue to analyze the impact of portfolio performance on the CLTDR before identifying future performance targets.

Objective 3: Reduce program administration costs.

Federal Student Aid will reduce the cost of administering the Title IV programs through strong financial, operational and budget management; the reengineering of overly complex business processes; and simplification of the business application and computing environment to reduce system complexity, minimize integration challenges, align contracts and reduce vendor management. Our aim is to improve the exchange of data with program participants and across the Federal Student Aid enterprise. In recent years, Federal Student Aid has maintained a relatively flat operating budget, while supporting continued increases in program volume and workload. Federal Student Aid’s ability to manage and control operating expenses is based on a philosophy of good fiscal management and continuous process improvement practices that

increase productivity and operational efficiencies as well as innovation in our products, services and supporting technologies. In FY 2007, we successfully:

- Continued to expand the ABC Model to facilitate reduction of administrative costs, identify process improvement opportunities and assist in budget formulation.
- Renegotiated the Common Services for Borrowers contract resulting in future savings.
- Continued to manage and control operating expenses through efficiencies, productivity gains and capital savings.
- Improved financial management of Federal Student Aid contracts through integration of performance, budget and acquisition processes.
- Optimized Federal Student Aid's return on procurement investment through improvements in the procurement planning process, support personnel and post-contract award assistance.
- Established Federal Student Aid cost library to improve cost estimation, budget planning, fiscal management and contract negotiation.
- Reduced interest paid to vendors for late payments.
- Significantly increased small-business participation in Federal Student Aid procurement through better internal controls, communications and management emphasis and support.

Performance Standards and Results

Performance standards were established to measure our ability to control costs in an environment of increasing workloads. Success relies on achieving economies of scale in our application, delivery, servicing and collection activities.

Metric	FY 2004	FY 2005	FY 2006*	FY 2007 (Target)	FY 2007* (Actual)	Performance
Reduce the Unit Cost to Process an Electronic FAFSA	**	**	\$ 5.04	\$ 4.86	\$ 4.34	Target Met
Reduce the Unit Cost of Originating and Disbursing Direct Loans and Pell Grants	**	**	\$ 4.42	\$ 4.82	\$ 4.03	Target Met
Reduce the Unit Cost of Servicing a Direct Loan Borrower	**	**	\$ 20.95	\$ 20.77	\$ 21.45	Target Not Met***
Reduce the Unit Cost of Collecting One Dollar in Default Status	**	**	\$ 0.14	\$ 0.14	\$ 0.13	Target Met

* Indicates year data was reported

** Data is not available because either 1) the Department was not collecting this data during the fiscal year indicated, 2) the project/metric did not exist or 3) the performance standard had not yet been established.

*** In FY 2007, Federal Student Aid met or exceeded cost reduction targets for Electronic FAFSA, Origination and Disbursement and Collections unit costs. However, Federal Student Aid did not meet its cost reduction target for Direct Loan Servicing because actual workload was slightly lower than the projected workload amount.

Objective 4: Improve human capital management.

Human capital management is a critical component of Federal Student Aid's current business operations and future initiatives. Federal Student Aid continues to grow as an organization that empowers individuals to perform at a high level of effectiveness and efficiency. Federal Student Aid is utilizing innovative hiring and employee development techniques aimed at attracting and retaining highly qualified individuals to create a more productive, results-oriented workforce. Additionally, the organization is committed to workforce development and training to ensure a skilled and highly qualified professional workforce. In FY 2007, we successfully:

- Continued to build leadership knowledge and skills at all levels of the organization, training 100% of new supervisors in our "home grown" Cornerstones of Supervision Program and almost 70% of existing managers in a range of leadership development programs, classes or workshops, furthering Federal Student Aid's leadership development and succession planning efforts.
- Developed and executed an organization-wide training plan supporting enterprise skills development in areas such as critical thinking, project management, policy and procedure development, statistical analysis, technical writing, and time management.
- Achieved an overall score of 90 (out of 100) on OPM's Performance Appraisal Assessment Tool for employee performance management practices. This is within the highest range possible and establishes Federal Student Aid as a model organization for our employee performance management practices.
- Achieved a clean audit from Office of Management and OPM of Federal Student Aid's Human Resources operations. The audit revealed no material findings, and Federal Student Aid was commended for our best practices in human resource management.
- Completed rollout of the Electronic Official Personnel Folder to all Federal Student Aid employees.
- Launched *Student Aid Front2Back*, an on-line course that provides an overview of the student aid process.

Performance Standards and Results

The performance standard for improving human capital management measures our ability to maintain a skilled and knowledgeable workforce. Specifically, the performance measures will identify our mission-critical competencies, identify where current or potential weaknesses exist and identify training plans for individuals to further develop competency/skills/knowledge.

Metric	FY 2004	FY 2005	FY 2006	FY 2007 (Target)	FY 2007 (Actual)	Performance
Use Training Resources to Develop a Highly Skilled Workforce to Ensure Competency in Mission Critical Skills/Knowledge	*	*	Leadership: Trained 100% of New Supervisors Trained 52% of Current Supervisors	Leadership: Train 95% of New Supervisors Train 60% of Current Supervisors	Leadership: Trained 100% of New Supervisors Trained 70% of Current Supervisors	Target Met
	*	*	Acquisitions: Trained 100% of Contracting Officials	Acquisitions: Train 100% of Contracting Officials	Acquisitions: Trained 100% of Contracting Officials	Target Met
	*	*	Project Management: Trained 100% of Key IT Project Managers	Project Management: Train 100% of Key IT Project Managers	Project Management: Trained 75% of Key IT Project Managers	Target Not Met**
	*	*	Federal Student Aid Business Knowledge: Trained 90% of New Employees	Federal Student Aid Business Knowledge: Train 90% of New Employees	Federal Student Aid Business Knowledge: Trained 100% of New Employees	Target Met
			Trained 100% of School Compliance Officials	Train 100% of School Compliance Officials	Trained 100% of School Compliance Officials	Target Met
			Trained 40% of General Workforce	Train 40% of General Workforce	Trained 100% of General Workforce	Target Met

* Data is not available because either 1) the Department was not collecting this data during the fiscal year indicated, 2) the project/metric did not exist or 3) the performance standard had not yet been established.

** In FY 2007, Federal Student Aid met or exceeded training targets for Leadership, Acquisitions, Federal Student Aid Business Knowledge training. However, Federal Student Aid did not meet is target for Project Management Training due to resource issues and competing work priorities.

Objective 5: Improve products and services to provide better customer service.

Federal Student Aid will make a continuous effort to improve products and services to students and their families and program participants such as schools, lenders and guaranty agencies. Being aware of the concerns of customers is a critical component of our efforts to improve federal student aid products and services. Federal Student Aid intends to reduce the complexity of our products and services, ensure that compliance is maintained, provide customers with 24-hour access and promote increased self-service opportunities for customers. In addition, Federal Student Aid will continue to develop strategies to provide integrated solutions for customers. In FY 2007, accomplishments included:

- Scored in the “Excellent” and “Good” range in the FY 2007 ACSI ratings for Federal Student Aid’s highest volume products and services – including Direct Loan Servicing, FAFSA on the Web, the COD and the LaRS.
- Continued the multi-year enterprise communications strategy that was launched in FY 2005 to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to its many stakeholders, including currently underserved communities.
- Launched a Federal Student Aid Public Service Campaign resulting in over 30,000 television airings generating over 500 million impressions worth an estimated \$13.3 million and over 90,000 radio airings generating over 250 million impressions worth almost \$12 million.
- Developed and launched the FAFSA4caster providing college-bound students and their families with an early estimation of financial aid eligibility prior to their senior year in high school.
- The Ombudsman’s office resolved over 17,000 disputes in FY 2007.

Performance Standards and Results

The following performance standards were established to measure our success in meeting and exceeding customer service goals. Specifically, success is realized with continuous improvement in our customer satisfaction scores for our four main systems.

Metric	FY 2004	FY 2005	FY 2006	FY 2007 (Target)	FY 2007 (Actual)	Performance*
Student Aid Application	81	81	80	85	80	Target Not Met
School Origination and Disbursement	72	76	77	76	81	Target Met
Lender Payment Processing	73	72	71	75	75	Target Met
Direct Loan Borrower Servicing	78	76	79	78	80	Target Met

* In FY 2007, Federal Student Aid met or exceeded customer satisfaction targets for the Origination and Disbursement, Lender Payment Processing and Direct Loan Servicing processes. However, Federal Student Aid did not meet its target for the student aid application process due to the continued evolution of e-commerce site functionality and rising consumer expectations. We anticipate updates to the site in the coming year will result in increased customer satisfaction.

Legislative and Regulatory Recommendations

Key among Federal Student Aid's mission responsibilities is the task of developing legislative recommendations. These recommendations customarily center on improving and simplifying the Title IV programs, minimizing administrative costs and improving program integrity. Our recommendations inform the Department's policymaking process, including its activities and decisions related to the reauthorization of the HEA. These activities are usually accomplished by direct contact with colleagues in the Department's Office of Postsecondary Education (OPE) at both the senior policy level and at a staff level. Federal Student Aid's recommendations also are key in the formulation of policy decisions in other offices, including senior staff in the Secretary's office and OMB. These efforts, while primarily carried out by Federal Student Aid's Policy Liaison and Implementation Staff, also involve other Federal Student Aid offices and senior managers. While a portion of this policy advising is accomplished on an ongoing, informal daily basis, Federal Student Aid staff contributed to policy decision-making in a more formalized way related to among other things legislation to implement a data match with the Internal Revenue Service and to allow the Department to accept statements from foreign schools that are prepared using international accounting standards.

Annual Bonus Awards

At the end of FY 2007, there were 57 Federal Student Aid senior managers. In addition, there are 12 senior managers who have achieved Senior Executive Service status. Six of the 57 senior managers and two of the 12 Senior Executive Service staff serve on the Federal Student Aid Executive Leadership Team and report directly to the Chief Operating Officer. The remaining 51 senior managers and 10 Senior Executive Service staff serve in a variety of senior positions and capacities within Federal Student Aid.

Ratings and awards for 43 of the 48 eligible senior managers who do not serve on the Executive Leadership Team were approved at the time of this writing as follows: 11 achieved a performance rating of Outstanding, 21 achieved a performance rating of Highly Successful, 11 achieved a performance rating of Successful. Three (3) senior managers were not eligible for a rating. Award amounts for those achieving an Outstanding rating ranged from a low of \$5,791 to a high of \$10,000, with a median award of \$9,840. Award amounts for those achieving a Highly Successful rating ranged from a low of \$2,830 to a high of \$10,000, with a median award of \$6,952. Those receiving a rating of Successful were not eligible for an award. The Department did not pay a performance bonus to either the Federal Student Aid Chief Operating Officer or the current Acting Chief Operating Officer in FY 2007.

FY 2007 performance ratings and bonuses for the six (6) senior managers who serve on Federal Student Aid's Executive Leadership Team and five (5) of the 51 other senior managers were not finalized at the time of this publication. Additionally, FY 2007 performance ratings and bonuses for the 12 Senior Executive Service staff, including the two who serve on Federal Student Aid's Executive Leadership Team, were not finalized at the time of this publication.

FY 2006 ratings and awards for the six (6) members of the Executive Leadership Team and the four (4) senior managers not available at the time of publication of the FY 2006 Annual Report were as follows: eight (8) achieved a performance rating of Outstanding and two (2) achieved a performance rating of Highly Successful. Award amounts ranged from a low of \$12,491 to a high of \$24,326 with a median award of \$20,150.

Report of the Federal Student Aid Ombudsman

FY 2007 marked the eighth anniversary of the Federal Student Aid Office of the Ombudsman. The office, established by the 1998 Amendments to the HEA of 1965 (as amended), uses informal dispute resolution processes to address issues and complaints from those who receive assistance through Title IV financial aid programs. To effectively resolve problems and issues, the office applies a collaborative approach when working with institutions of higher education, lenders, guaranty agencies, loan servicers and other participants in the student aid programs. By analyzing consolidated complaint data from the Ombudsman Case Tracking System (OCTS), the office identifies broad systemic issues impacting Title IV programs. Implementation of systemic solutions can at times prevent problems, an approach preferable to resolving individual problems as they occur. Also based on information from OCTS, the Ombudsman creates internal and external reports for Federal Student Aid and the industry in general.

In the outreach arena, information on the existence and role of the Federal Student Aid Office of the Ombudsman is disseminated to the industry and borrowers throughout the student aid life cycle. The office's website (www.ombudsman.ed.gov) was completely redesigned in 2007, and helps individuals resolve loan problems independently, learn about student aid information and resources and submit issues or complaints electronically for Ombudsman analysis and resolution. The office produces printed materials for the higher education community (e.g., Ombudsman brochure and the monthly Ombudsman newsletter) regarding Ombudsman services and industry news, produces tailored reports for individual agency use, and meets with guaranty agencies and others to identify and address issues common to the industry. Coordination with guaranty agencies and others was especially successful in 2007 because of the formal establishment of the Student Loan Ombudsman Caucus (Caucus). The Caucus brings loan agency Ombudsmen and interested parties together to discuss emerging industry trends, provide training, and develop aggregated information on systemic issues.

Since its inception, the Federal Student Aid Ombudsman Office has handled more than 119,000 complaints, including 17,496 in FY 2007, an increase of 603 over FY 2006. The office resolved more than 73 percent of FY 2007 issues within three days of the initial issue receipt, and took an average of 90 days to resolve 4,786 issues requiring additional research. Of the cases requiring additional effort, individual borrowers had an average of seven loans. Only 16 percent of those borrowers' loans are in default, 45 percent of the loans have been in repayment less than five years, and 78 percent of those loans are FFEL.

In FY 2007, Loan Consolidation was the most common Ombudsman issue. Almost one in four of all research cases involved a question or disagreement related to Loan Consolidation. The frequency of Loan Consolidation reversals rose dramatically in FY 2007. Nearly 40% of all Loan Consolidation cases involved customers seeking to have their Loan Consolidation reversed, usually due to business practices surrounding electronic signatures. Only 18.5% of all FY 2006 Loan Consolidation cases involved reversal.

Loan Cancellation/Discharge represents another top problem area. Case analysis shows that more customers escalate Loan Cancellation/Discharge issues to executive or legislative offices than any other type of Ombudsman issue, demonstrating that more emphasis is needed on early resolution of these cases. The most common problem within the Loan Cancellation/Discharge category relates to Total and Permanent Disability (TPD). Review of TPD cases reveals that undue process complexity, lack of transparency and applicant burden are significant problems. Using case data and related materials, the Ombudsman prepared a report that discusses the TPD process, identifies specific problems and offers recommendations for immediate process improvement and long-term regulatory and statutory changes.

Other prevalent Ombudsman research issues relate to borrowers' Account Balances, Repayment Plans/Amounts, and Default. The top five Ombudsman issues account for almost 70% of the case volume requiring additional research.

Throughout the year, the Ombudsman responds to numerous inquiries received from the Office of the Secretary, the GAO, and the press regarding student aid issues. The Ombudsman also contributes to Enterprise recommendations and legislative proposals, and case summary information is used to inform program compliance activities. In addition, the office reaches out to other agencies when problems require interagency communication and partnerships. For instance, the Ombudsman participates in ongoing communication with the Federal Trade Commission regarding deceptive student loan practices.

As part of the Federal Student Aid PBO, the Ombudsman measures effectiveness by obtaining customer satisfaction feedback through independently conducted telephone surveys following case closure. Closed cases are chosen at random, and customers are asked to rate service accessibility, Ombudsman representatives' knowledge, timeliness of case resolution, level of satisfaction with the resolution, and overall service. On a scale of 1 – 5, with 5 the highest rating, survey results are calculated weekly and cumulatively. Only ratings of 4.0 or higher meet the Ombudsman customer satisfaction performance goal. The average FY 2007 customer satisfaction rating was 4.40. For FY 2008, the office is developing additional measures of performance that focus on the Ombudsman web site and the call center customer service telephone menu.

Message from the Chief Financial Officer

Through our Title IV programs, Federal Student Aid has delivered or supported the delivery of \$82 billion in grant, work-study, and loan assistance to 11 million students and their families in FY 2007 for postsecondary education. Our staff and business partners take great pride in the fact that we are serving the American people by helping so many individuals further their education. Knowing that we are serving such an important and worthy cause, we have strived over the past year to maintain and improve upon our high standards of financial management and reporting. Our accomplishments include:

- Received an unqualified opinion on our financial statements for the sixth consecutive year.
- Continued to have no material weaknesses identified in our Report on Internal Control for the fifth consecutive year.
- Continued to provide reasonable assurance to the Department for our internal control over financial reporting.



John W. Hurt, III
Acting Chief Financial Officer

Federal Student Aid continued to implement an integrated process in FY 2007 to support a Department-wide assurance statement on the effectiveness of internal control over financial reporting, in compliance with OMB Circular A-123, Appendix A. This process required Federal Student Aid to perform the following tasks:

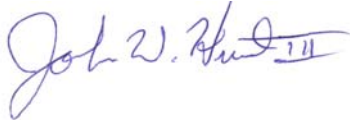
- Conduct internal risk assessments;
- Update its documentation of organizational and process hierarchies;
- Update Federal Student Aid’s entity and process level control libraries;
- Reassess the effectiveness of Federal Student Aid controls over financial reporting;
- Coordinate remediation activities and retesting; and
- Report on status and results internally and to the Department.

The successful results of this assessment effort are described further in the “Analysis of Federal Student Aid’s Systems, Controls and Legal Compliance” section.

Through cooperative efforts among the Department’s Office of the Chief Financial Officer, Budget Service, and Federal Student Aid, the Department continues to make progress on two previous reportable conditions: credit reform estimation and controls surrounding information systems. During the next fiscal year, Federal Student Aid is committed to continuing these cooperative efforts towards resolving these reportable conditions.

As described in the “Analysis of Federal Student Aid’s Systems, Controls and Legal Compliance” section, Federal Student Aid identified and disclosed an FMFIA material weakness related to oversight of Guaranty Agencies, Lenders and Servicers. To address these internal control deficiencies, Federal Student Aid has re-evaluated its overall approach to oversight and monitoring of financial institutions, resulting in numerous corrective actions. Together, these corrective actions form a broader plan to provide the necessary oversight and monitoring to ensure compliance with the HEA, regulations, and guidance.

Federal Student Aid will continue to review audit findings and recommendations from all oversight organizations and from our own self-assessments. We will ensure that Federal Student Aid management takes full responsibility for both the problems identified and the required solutions. Federal Student Aid looks forward to working with the Office of Inspector General and all other oversight organizations to ensure that we remain compliant with the Higher Education Act while we minimize fraud, waste, and abuse.



John W. Hurt III, CGFM
Acting Chief Financial Officer

November 9, 2007

Principal Financial Statements and Notes to Principal Financial Statements

Principal Financial Statements

United States Department of Education
Federal Student Aid
Consolidated Balance Sheet
As of September 30, 2007 and 2006

(Dollars in Millions)

	Fiscal Year 2007	Fiscal Year 2006
Assets:		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 58,141	\$ 67,576
Total Intragovernmental	58,141	67,576
Cash and Other Monetary Assets (Note 5)	1,103	566
Accounts Receivable, Net (Note 4)	36	31
Credit Program Receivables, Net (Note 6)	115,752	106,383
General Property, Plant and Equipment, Net	34	14
Other Assets		1
Total Assets (Note 2)	\$ 175,066	\$ 174,571
Liabilities:		
Intragovernmental:		
Debt (Note 7)	\$ 103,893	\$ 105,430
Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 5)	1,103	566
Payable to Treasury (Note 6)	5,351	5,519
Other Intragovernmental Liabilities (Note 8)	190	2
Total Intragovernmental	110,537	111,517
Accounts Payable	756	609
Accrued Grant Liability (Note 9)	1,030	1,250
Liabilities for Loan Guarantees (Note 6)	50,874	52,453
Other Liabilities (Note 8)	23	255
Total Liabilities	\$ 163,220	\$ 166,084
Commitments and Contingencies (Note 15)		
Net Position:		
Unexpended Appropriations	\$ 14,420	\$ 13,639
Cumulative Results of Operations	(2,574)	(5,152)
Total Net Position (Note 10)	\$ 11,846	\$ 8,487
Total Liabilities and Net Position	\$ 175,066	\$ 174,571

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Net Cost
For the Years Ended September 30, 2007 and 2006
(Dollars in Millions)

	<u>Fiscal Year</u> <u>2007</u>	<u>Fiscal Year</u> <u>2006</u>
Program Costs		
Enhancement of Postsecondary and Adult Education		
Gross Costs	\$ 27,419	\$ 58,803
Less: Earned Revenue	7,911	7,772
Net Program Costs	19,508	51,031
Total Program Costs	\$ 19,508	\$ 51,031
Net Cost of Operations (Notes 11 & 14)	\$ 19,508	\$ 51,031

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Changes in Net Position
For the Years Ended September 30, 2007 and 2006

(Dollars in Millions)

	Fiscal Year 2007		Fiscal Year 2006	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	\$ (5,152)	\$ 13,639	\$ (4,547)	\$ 8,597
Budgetary Financing Sources:				
Appropriations Received		\$ 29,484		\$ 56,221
Appropriations Transferred - in/out		(1)		(1)
Other Adjustments (rescissions, etc)		(844)		(861)
Appropriations Used	\$ 27,858	(27,858)	\$ 50,318	(50,318)
Nonexpenditure Financing Sources - Transfers-Out			(11)	
Other Financing Sources:				
Imputed Financing from Costs Absorbed by Others	\$ 9		\$ 8	
Others	(5,781)		111	
Total Financing Sources	\$ 22,086	\$ 781	\$ 50,426	\$ 5,042
Net Cost of Operations	\$ (19,508)	\$	\$ (51,031)	\$
Net Change	\$ 2,578	\$ 781	\$ (605)	\$ 5,042
Ending Balances (Note 10)	\$ (2,574)	\$ 14,420	\$ (5,152)	\$ 13,639

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Combined Statement of Budgetary Resources
For the Years Ended September 30, 2007 and 2006

(Dollars in Millions)

	Fiscal Year 2007		Fiscal Year 2006	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources:				
Unobligated balance, brought forward, October 1:	\$ 4,387	\$ 46,490	\$ 1,429	\$ 22,817
Recoveries of prior year Unpaid Obligations	1,356	3,043	1,005	3,450
Budgetary Authority:				
Appropriations	29,484		56,221	105
Borrowing Authority (Note 13)		19,570		35,073
Spending authority from offsetting collections (gross):				
Earned				
Collected	1,691	37,019	1,967	77,367
Change in unfiled customer orders				
Without advance from Federal Sources		(30)		(4)
Subtotal	\$ 31,175	\$ 56,559	\$ 58,188	\$ 112,541
Nonexpenditure transfers, net	(1)			
Permanently not available	(1,845)	(19,429)	(2,861)	(32,230)
Total Budgetary Resources (Note 13)	\$ 35,072	\$ 86,663	\$ 57,761	\$ 106,578
Status of Budgetary Resources:				
Obligations incurred: (Note 13)				
Direct	\$ 30,623	\$ 49,871	\$ 53,374	\$ 60,088
Subtotal	\$ 30,623	\$ 49,871	\$ 53,374	\$ 60,088
Unobligated Balances:				
Apportioned	2,504	321	3,437	
Subtotal	\$ 2,504	\$ 321	\$ 3,437	\$
Unobligated Balance not available	1,945	36,471	950	46,490
Total Status of Budgetary Resources	\$ 35,072	\$ 86,663	\$ 57,761	\$ 106,578
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	\$ 11,584	\$ 12,941	\$ 9,225	\$ 10,763
Uncollected customer payments from Federal Sources, brought forward, October 1		(30)		(34)
Total, unpaid obligated balance, brought forward, net	\$ 11,584	\$ 12,911	\$ 9,225	\$ 10,729
Obligations Incurred net (+/-)	30,623	49,871	53,374	60,088
Gross Outlays	(28,366)	(45,344)	(50,010)	(54,460)
Recoveries of prior year unpaid obligations, actual	(1,356)	(3,043)	(1,005)	(3,450)
Change in uncollected customer payments from Federal Sources (+/-)		30		4
Obligated Balance, net, end of period	\$ 12,485	\$ 14,425	\$ 11,584	\$ 12,941
Unpaid Obligations				
Uncollected customer payments from Federal Sources				(30)
Total, unpaid obligated balance, net, end of period	\$ 12,485	\$ 14,425	\$ 11,584	\$ 12,911
Net Outlays				
Net Outlays:				
Gross Outlays	\$ 28,366	\$ 45,344	\$ 50,010	\$ 54,460
Offsetting collections	(1,691)	(37,019)	(1,967)	(77,367)
Distributed Offsetting receipts	(35)	(4,700)	(51)	
Net Outlays (Note 13)	\$ 26,640	\$ 3,625	\$ 47,992	\$ (22,907)

The accompanying notes are an integral part of these statements.

Notes to Principal Financial Statements For the Years Ended September 30, 2007 and 2006

Note 1. Summary of Significant Accounting Policies

Reporting Entity

Federal Student Aid was created as a Performance Based Organization (PBO) within the U.S. Department of Education (the Department) under the *Higher Education Act of 1965 (HEA)*, as amended, from previously existing Department student financial assistance programs. Federal Student Aid operates under the PBO mandate to develop a management structure driven by strong incentives to manage for results. Federal Student Aid's primary goal is to assist lower-income and middle-income students in overcoming the financial barriers that make it difficult to attend and complete postsecondary education. It is responsible for administering direct loans, guaranteed loans, and grant programs.

The William D. Ford Federal Direct Loan (Direct Loan) Program, authorized by the *Student Loan Reform Act of 1993*, enables Federal Student Aid to make loans directly to eligible undergraduate and graduate students and their parents through participating schools. Federal Student Aid borrows money from the U.S. Department of the Treasury (Treasury) to fund the loans. The program provides interest subsidies for eligible borrowers.

The Federal Family Education Loan (FFEL) Program, authorized by the HEA, cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students.

Under the Direct Loan and FFEL programs, loans are made to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public or private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents, based on eligibility criteria, receive loans regardless of income or credit rating. Student borrowers who demonstrate financial need also receive federal interest subsidies.

Grant appropriations funding the Federal Pell Grant Program and campus-based student aid programs enable Federal Student Aid to provide educational grants and other financial assistance to eligible applicants, which are not repaid to the federal government. The Pell Grant Program provides grant aid to low-income and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The campus-based student aid programs provide educational grants and other financial assistance to eligible applicants. These programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan. Campus-based programs are not material to these statements and have been included with other programs reported under grant programs.

Basis of Accounting and Presentation

These financial statements have been prepared to report the financial position, net cost of operations, changes in net position and budgetary resources of the Federal Student Aid reporting group, as required by the *Chief Financial Officers Act of 1990* and the *Government Management Reform Act of 1994*. The financial statements were prepared from the books and records of Federal Student Aid, in accordance with accounting principles generally accepted in the United

States of America for federal entities, issued by the Federal Accounting Standards Advisory Board (FASAB) and OMB Circular No. A-136, *Financial Reporting Requirements*, revised as of June 29, 2007. These financial statements are different from the financial reports prepared by the Department pursuant to OMB directives that are used to monitor and control Federal Student Aid's use of budgetary resources.

Federal Student Aid's financial statements should be read with the realization they represent the reporting group, Federal Student Aid, within the Department of Education, which is itself a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation providing resources and legal authority to do so.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

Transactions and balances among Federal Student Aid funds have been eliminated from the Consolidated Balance Sheet.

In previous years, a reconciliation of Net Cost of Operations to Budget was accomplished by presenting the Statement of Financing, a basic financial statement. Effective for FY 2007, OMB and the Chief Financial Officers' Council decided this reconciliation would be better placed and understood as a footnote rather than as a basic financial statement. (See Note 14)

Use of Estimates

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

The *Federal Credit Reform Act of 1990* (Credit Reform Act) underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as "subsidy cost". Under the Credit Reform Act, subsidy costs for loans obligated beginning in FY 1992 are estimated at the net present value of projected lifetime costs in the year the loan is obligated. Subsidy costs are then revalued annually through the reestimate process.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these components may create significant changes to the estimate.

Federal Student Aid and the Department estimate all future cash flows associated with the Direct Loan and FFEL programs. Projected cash flows are used to develop subsidy estimates. Subsidy

cost can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy cost is recorded as the initial amount of the loan guarantee liability when guarantees are made (the loan liability) or as a valuation allowance to government-owned loans and interest receivable (i.e., direct and defaulted guaranteed loans).

Federal Student Aid and the Department use a computerized cash flow projection Student Loan Model to calculate subsidy estimates for the Direct Loan and FFEL programs. Each year, the Department reevaluates the estimation methods related to changing conditions. Federal Student Aid and the Department use a probabilistic technique to forecast interest rates based on different methods to establish the relationship between an event's occurrence and the magnitude of its probability. The Department's approach estimates interest rates under numerous scenarios and then bases interest rates on the average interest rates weighted by the assumed probability of each scenario occurring. Probabilistic methodology facilitates the modeling of the Department's unique loan programs.

For each program, cash flows are projected over the life of the loans, aggregated by loan type, cohort year, and risk category. The loan's cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for profit) schools.

Estimates reflected in these statements were prepared using assumptions developed for the FY 2008 Mid-Session Review, a government-wide exercise required annually by OMB. Assumptions and their impact are updated after the Mid-Session Review to account for significant subsequent changes in activity. These estimates are based on the most current information available to Federal Student Aid and the Department at the time the financial statements are prepared. Federal Student Aid and Department management have a process to review these estimates in the context of subsequent changes in activity and assumptions, and to reflect the impact of these changes as appropriate.

Federal Student Aid and the Department recognize that the cash flow projections and the sensitivity of the changes in assumptions can have a significant impact on the estimates. Management has attempted to mitigate fluctuations in the estimate by using trend analysis to project future cash flows. Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a minimal change in the projected long-term interest rate charged to borrowers could change the current subsidy reestimate by a significant amount. (See Note 6)

Budget Authority

Budget authority is the authorization provided by law for the Department and Federal Student Aid to incur financial obligations that will result in outlays. Federal Student Aid's budgetary resources include (1) unobligated balances of resources from prior years, (2) recoveries of prior-year obligations, and (3) new resources—appropriations, authority to borrow from Treasury, and spending authority from collections.

Authority to borrow from Treasury provides most of the funding for the loan principal disbursements made under the Direct Loan Program. Subsidy and administrative costs of the program are funded by appropriations. Budgetary resources from collections are used primarily

to repay Federal Student Aid's debt to Treasury. Unobligated balances associated with resources expiring at the end of the FY remain available for five years after expiration only for upward adjustments of prior year obligations, after which they are canceled and may not be used. Unobligated balances of resources that have not expired at year-end may have new obligations placed against them, as well as net upward adjustments of prior year obligations.

Major sources of collections include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related fees, and (3) interest from Treasury on balances in certain credit program accounts that make and administer loans and guarantees.

Borrowing authority is an indefinite budgetary resource authorized under the Credit Reform Act, as amended. This resource, when realized, finances the unsubsidized portion of the Direct Loan portfolio. In addition, borrowing authority is requested in advance of expected collections to cover negative subsidy. Treasury prescribes the terms and conditions of borrowing authority and lends to the Direct Loan Financing Account amounts as appropriate. Amounts borrowed, but not yet disbursed, are included in uninvested funds and earn interest. Treasury uses the same weighted average interest rates for both the interest charged on borrowed funds and the interest earned on uninvested funds. The Department may carry forward borrowing authority to future fiscal years provided that cohorts are disbursing loans. All borrowings from Treasury are effective on October 1 of the current fiscal year, regardless of when the Department borrowed the funds, except for amounts borrowed to make annual interest payments.

Assets

Assets are classified as either entity or non-entity assets. Entity assets are those that the Department has authority to use for its operations. Non-entity assets are those held by the Department but not available for use in its operations. The Department combines its entity and non-entity assets on the face of the balance sheet and discloses its non-entity assets in the notes. (See Note 2)

Fund Balance with Treasury

The Fund Balance with Treasury includes general, revolving, and other funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for Federal Student Aid. Federal Student Aid's records are reconciled with those of Treasury.

A portion of the general fund is funded in advance by multi-year appropriations for expenditures anticipated during the current and future fiscal years. Revolving funds conduct continuing cycles of businesslike activity and do not require annual appropriations. Their fund balance is derived from borrowings and collections from the public and other federal agencies. Other funds, which are non-budgetary, primarily consist of deposit funds.

Available unobligated balances represent amounts that are apportioned for obligation in the current fiscal year. Unavailable unobligated balances represent amounts that are not apportioned for obligation during the current fiscal year and expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include receivables for undelivered orders and unpaid expended authority. (See Note 3)

Accounts Receivable

Accounts receivable are amounts due to Federal Student Aid from the public and other federal agencies. Receivables from the public result from overpayments to recipients of grants and other financial assistance programs, and disputed costs resulting from audits of educational assistance programs. Amounts due from other federal agencies result from reimbursable agreements entered into by Federal Student Aid with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts. Estimates for the allowance for loss on uncollectible accounts are based on historical data. (See Note 4)

Cash and Other Monetary Assets

Cash and Other Monetary Assets consist of Guaranty Agency reserves that represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 5) and are offset by a corresponding liability due to Treasury. Guaranty Agency reserves include initial federal start-up funds, receipts of federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income, administrative cost allowances, and other assets.

Section 422A of the HEA required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (Federal Fund) and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency, in whole or in part with federal funds, are the property of the United States and reflected in the *Budget of the United States Government*. However, such ownership by the federal government is independent of the actual control of the assets. The net value of the Federal Fund will change from year to year. Recalls are payments to the Department from Guaranty Agency Federal Funds, which increase Fund Balance with Treasury. Recalls were remitted to Treasury at fiscal year-end.

Federal Student Aid disburses funds to a Guaranty Agency through its Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for amounts an agency borrows from the Federal Fund (as authorized under Section 422A of the HEA). The Operating Fund is used by the Guaranty Agency to fulfill responsibilities that include repaying money borrowed from the Federal Fund, and performing default aversion and collection activities. (See Notes 2 and 5)

Credit Program Receivables and Liabilities for Loan Guarantees

The financial statements reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Credit Reform Act. Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy". The difference is the present value of the cash flows to and from Federal Student Aid that are expected from the receivables over their projected lives. Similarly, liabilities for loan guarantees are valued at the present value of the cash outflows from Federal Student Aid less the present value of related inflows. The estimated present value of net long-term cash outflows of Federal Student Aid for subsidized costs is net of recoveries, interest supplements, and offsetting fees. Federal Student Aid records all credit program loans and loan guarantees at their present values.

Components of subsidy costs for loans and guarantees include defaults (net of recoveries), contractual payments to third-party, private loan collectors who receive a set percentage of amounts collected, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department and Federal Student Aid on its borrowings from Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third-party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are reestimated each year. (See Note 6)

General Property, Plant and Equipment

In accordance with the Department's policy, Federal Student Aid capitalizes single items of property and equipment with a cost of \$50,000 or more that have an estimated useful life greater than two years. Additionally, Federal Student Aid capitalizes bulk purchases of property and equipment with an aggregate cost of \$500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Internal Use Software meeting the above cost and useful life criteria is also capitalized. Internal Use Software is either purchased off the shelf, internally developed, or contractor developed solely to meet the agency's internal needs.

The Department adopted the following useful lives for its major classes of depreciable property and equipment:

Major Classes of Depreciable Property and Equipment	Years
Information Technology, Internal Use Software and Telecommunications Equipment	3
Furniture and Fixtures	5

Liabilities

Liabilities represent actual and estimated amounts to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by Federal Student Aid or the Department without budget authority. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, and there is no certainty the appropriation will be enacted. The government acting in its sovereign capacity can abrogate liabilities that arise from activities other than contracts. FFEL Program and Direct Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

Debt

Federal Student Aid and the Department borrow to provide funding for direct loans to students. The liability to Treasury from borrowings represents unpaid principal on the loans at year-end. Federal Student Aid repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury, with such rates generally fixed based on the rate for 10-year securities. As discussed in Note 6, the interest received by Federal Student Aid from borrowers will vary from the rate paid to Treasury. Principal and interest payments to Treasury are made annually. (See Note 7)

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by Federal Student Aid for expenditures incurred by grantees prior to their receiving grant funds to cover the expenditures. The amount is estimated using statistical sampling techniques. (See Note 9)

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except for federal credit financing and liquidating funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 10)

Personnel Compensation and Other Employee Benefits

Annual, Sick and Other Leave. The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans and Other Retirement Benefits. Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay.

FERS consists of Social Security, a basic annuity plan, and the Thrift Savings Plan. The Department and the employee contribute to Social Security and the basic annuity plan at rates prescribed by law. In addition, the Department is required to contribute to the Thrift Savings Plan a minimum of 1 percent per year of the basic pay of employees covered by this system and to match voluntary employee contributions up to 3 percent of the employee's basic pay, and one-half of contributions between 3 percent and 5 percent of basic pay. For FERS employees, the Department also contributes the employer's share of Medicare.

Contributions for CSRS, FERS and other retirement benefits are insufficient to fully fund the programs, which are subsidized by the OPM. The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees.

Federal Employees' Compensation Act. The *Federal Employees' Compensation Act* (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA Program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two- to three-year time period between payment by Labor and reimbursement by the Department. As a result, a liability is recognized for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using OMB economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost-of-living adjustments) and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

The estimated projections are evaluated by Labor to ensure that the resulting projections are reliable. The analysis is based on four tests: (1) a sensitivity analysis of the model to economic assumptions, (2) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual incremental payments, (3) a comparison of the incremental paid losses per case (a measure of case-severity) in charge back year 2007 to the average pattern observed during the most current three charge back years, and (4) a comparison of the estimated liability per case in the 2007 projection to the average pattern for the projections of the most recent three years.

A portion of the estimated liability for disability benefits assigned to the Department under the FECA Program is accrued by Federal Student Aid. The accrual is based on the present value of estimated net future payments by the Department of Labor.

Intragovernmental Transactions

Federal Student Aid's financial activities interact with and are dependent upon the financial activity of the centralized management functions of the federal government. Due to financial regulation and management control by OMB and Treasury, operations may not be conducted and financial positions may not be reported as they would if Federal Student Aid were a separate, unrelated entity.

Note 2. Non-Entity Assets

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Non-Entity Assets		
Intragovernmental		
Fund Balance with Treasury	\$ 9	\$ 20
Total Intragovernmental	<u>9</u>	<u>20</u>
With the Public		
Cash and Other Monetary Assets	1,103	566
Credit Program Receivables, Net	<u>188</u>	<u>192</u>
Total With the Public	<u>1,291</u>	<u>758</u>
Total Non-Entity Assets	1,300	778
Entity Assets	<u>173,766</u>	<u>173,793</u>
Total Assets	<u>\$ 175,066</u>	<u>\$ 174,571</u>

Non-entity intragovernmental assets primarily consist of deposit fund balances. Non-entity assets with the public primarily consist of Guaranty Agency reserves (See Note 5) and Perkins Program Loan Receivables (See Note 6).

Note 3. Fund Balance with Treasury

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Fund Balances		
General Funds	\$ 15,829	\$ 15,393
Revolving Funds	42,305	52,175
Other Funds	<u>7</u>	<u>8</u>
Fund Balance with Treasury	<u>\$ 58,141</u>	<u>\$ 67,576</u>
 Status of Fund Balance with Treasury		
<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Unobligated Balance		
Available	\$ 2,825	\$ 3,437
Unavailable	37,313	46,874
Obligated Balance, Not Yet Disbursed	17,996	17,257
Non-Budgetary FBWT	<u>7</u>	<u>8</u>
Fund Balance with Treasury	<u>\$ 58,141</u>	<u>\$ 67,576</u>

Note 4. Accounts Receivable

<u>(Dollars in Millions)</u>	2007		
	<u>Gross Receivables</u>	<u>Allowance</u>	<u>Net Receivables</u>
Intragovernmental	\$ -	\$ -	\$ -
With the Public	53	(17)	36
Accounts Receivable	\$ 53	\$ (17)	\$ 36

<u>(Dollars in Millions)</u>	2006		
	<u>Gross Receivables</u>	<u>Allowance</u>	<u>Net Receivables</u>
Intragovernmental	\$ -	\$ -	\$ -
With the Public	50	(19)	31
Accounts Receivable	\$ 50	\$ (19)	\$ 31

Note 5. Cash and Other Monetary Assets

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Beginning Balance, Cash and Other Monetary Assets	\$ 566	\$ 888
Valuation Increase (Decrease) in Guaranty Agency Federal Funds	793	(29)
Less: Collections from Guaranty Agency Federal Funds		
Statutory Recall Amounts Collected from GAs	82	82
Excess Collections Remitted by GAs	174	211
Net Collections	256	293
Ending Balance, Cash and Other Monetary Assets	\$ 1,103	\$ 566

Cash and Other Monetary Assets consist of Guaranty Agency reserves and represent non-entity assets. The \$537 million net increase in the Federal Fund from FY 2006 to FY 2007 reflects the impact of Guaranty Agencies' ongoing federal operations. Of this increase, \$185 million represents the first full-year collection of the statutory 1 percent loan insurance premium by Guaranty Agencies. An additional \$489 million reflects the clarification and refinement of the calculation of the allowance for loss on the Federal Fund. These increases are partially offset by amounts remitted to the Department by the Guaranty Agencies, which consist of statutory recall amounts and excess collections.

Changes in the valuation of the Federal Fund increase or decrease the Department's cash and other monetary assets with a corresponding change in the Payable to Treasury.

Note 6. Credit Programs for Higher Education

The federal government makes loans directly to students and parents through participating schools under the Direct Loan Program. Loans are originated and serviced through contracts with private vendors. Private lender loans to students and parents are insured by the federal government under the FFEL Program. FFEL loans are guaranteed by the federal government against default, with state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees.

Beginning with FFEL loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default. Guaranty Agencies also began paying a portion of the cost (in most cases, 5 percent) of each defaulted loan from federal reserves they hold in trust. (See Note 5) FFEL lender participants receive statutorily set federal interest and special allowance subsidies. Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and loan cancellations. The same methodology is used to estimate the allowance on Direct Loan receivables.

The Department disbursed approximately \$15.7 billion in direct loans to eligible borrowers in FY 2007 and approximately \$32.3 billion in FY 2006. Loans typically are disbursed in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Half of all loan volume is obligated in the fourth quarter of a fiscal year. Regardless of the fiscal year in which they occur, disbursements are tracked by cohort as determined by the date of obligation rather than disbursement.

As of September 30, 2007 and 2006, total principal balances outstanding of guaranteed loans held by lenders were approximately \$363 billion and \$325 billion, respectively. As of September 30, 2007 and 2006, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately \$359 billion and \$321 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their Federal Funds. Payments by Guaranty Agencies do not reduce government exposure because they are made from the Federal Fund administered by the agencies but owned by the federal government.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection, and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection. Accrued interest on the subrogated loan is calculated but only realized upon collection.

Approximately 7 percent of loan commitments made in an individual fiscal year are never disbursed due to the nature of the loan commitment process. That portion of a loan cohort that does disburse, approximately 93 percent, will do so over two years. Schools establish a loan

commitment upon receipt of an aid application. The loan commitment may occur before a student has been accepted by the school or begins classes. For direct loans committed in the 2007 cohort, an estimated \$1.6 billion will never be disbursed; for guaranteed loans committed in the 2007 cohort, an estimated \$10.4 billion will never be disbursed. Direct loan schools may originate loans through a cash advance from the Department or by advancing their own funds in anticipation of reimbursement from the Department.

Loan Consolidations

The Department permits borrowers to prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. Under the Credit Reform Act and requirements provided by OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, the retirement of loans being consolidated is considered a receipt of principal and interest. This receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or nonperforming, in any given cohort are paid off in their original cohort, and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in establishing the subsidy rate for defaults. The effect of new consolidations is reflected in subsidy expense for the current year cohort, while the effect on prior cohorts is reflected in the reestimate. The loan liability and net receivables include estimates of future prepayments of existing loans through consolidations. They do not reflect costs associated with anticipated future consolidation loans.

On July 1, 2007, variable student loan interest rates increased by 0.08 percentage points to 7.22 percent from 7.14 percent. This change in variable interest rates is applicable to loans first disbursed on or after July 1, 2007, and is insignificant compared to the prior year change of nearly 2 percentage points. As a result, the number of student loan consolidations decreased. The lower consolidated loan volume was also due to last year's legislative changes. Direct loan consolidation disbursements for FY 2007 were \$3.6 billion and for FY 2006 were \$19.9 billion.

Based on current estimates, the prepayment of the underlying FFEL loans produces significant savings through the elimination of future special allowance payments. New consolidations are reflected in the 2007 cohort resulting in increased prepayments of underlying loans from prior cohorts.

Credit Program Receivables, Net

(Dollars in Millions)	2007	2006
Direct Loan Program Loan Receivables, Net	\$ 99,002	\$ 92,603
FFEL Program Loan Receivables, Net	16,562	13,588
Perkins Program Loan Receivables, Net	188	192
Credit Program Receivables, Net	\$ 115,752	\$ 106,383

The following schedules summarize the Direct Loan and defaulted FFEL principal and related interest receivable, net or inclusive of the allowance for subsidy.

Direct Loan Program Receivables		
(Dollars in Millions)	2007	2006
Principal Receivable	\$ 102,440	\$ 97,306
Interest Receivable	4,807	3,702
Receivables	107,247	101,008
Less: Allowance for Subsidy	8,245	8,405
Credit Program Receivables, Net	\$ 99,002	\$ 92,603

Of the \$107.2 billion in Direct Loan receivables as of September 30, 2007, \$9.3 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2006, \$8.1 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group out of the \$101.0 billion total receivable.

FFEL Program Receivables						
(Dollars in Millions)	2007			2006		
	Pre-1992	Post-1991	Total	Pre-1992	Post-1991	Total
Principal Receivable	\$ 8,208	\$ 13,324	\$ 21,532	\$ 8,730	\$ 10,263	\$ 18,993
Interest Receivable	224	1,957	2,181	336	1,823	2,159
Receivables	8,432	15,281	23,713	9,066	12,086	21,152
Less: Allowance for Subsidy	4,396	2,755	7,151	4,717	2,847	7,564
Credit Program Receivables, Net	\$ 4,036	\$ 12,526	\$ 16,562	\$ 4,349	\$ 9,239	\$ 13,588

Loan Modifications

According to OMB Circular No. A-11, any government action that differs from actions assumed in the baseline estimate of cash flows and changes the estimated cost of an outstanding direct loan or loan guarantee is defined as a modification. Loan modifications are recognized under the same accounting principle for upward or downward adjustments to subsidy cost and for the recordation of modification adjustment transfer gains or losses.

Separate amounts are calculated for modification costs and modification adjustment transfers. Modification adjustment transfers are required to adjust for the difference between current discount rates used to calculate modification costs and the discount rates used to calculate cohort interest expense and revenue.

2006 Modification

The *Deficit Reduction Act of 2005* (P.L. 109-171) (Deficit Reduction Act) included provisions revising the payment of account maintenance fees, Guaranty Agency retention on default collections, and an expansion of deferment eligibility for military borrowers performing eligible service. The Deficit Reduction Act shifted the payment of account maintenance fees, authorized under Section 458 of the HEA, to subsidy cost from administration funds or from the Federal Fund.

Beginning October 1, 2006, the Deficit Reduction Act required Guaranty Agencies to return to the Department a portion of collection charges on defaulted loans paid off through consolidation equal to 8.5 percent of the outstanding principal and interest. Under that Act, beginning October 1, 2009, Guaranty Agencies would be required to return the entire 18.5 percent on collections through consolidation that exceed 45 percent of their overall collections. In addition, the revised military deferment provisions provide a maximum three-year deferment for soldiers serving in a war zone who have outstanding loans originated after July 1, 2001.

The FFEL Program recognized \$1.7 billion and the Direct Loan Program recognized \$7 million in modification costs in FY 2006. The FFEL Program also recognized a net modification adjustment transfer gain of \$94 million, while the Direct Loan Program recognized a net gain of \$134 thousand.

Direct Loan Program Reconciliation of Allowance for Subsidy

(Dollars in Millions)	2007	2006
Beginning Balance, Allowance for Subsidy	\$ 8,405	\$ 2,132
Components of Subsidy Transfers		
Interest Rate Differential	(846)	(601)
Defaults, Net of Recoveries	422	1,226
Fees	(398)	(403)
Other	1,117	1,566
Current Year Subsidy Transfers	295	1,788
Components of Subsidy Re-estimates		
Interest Rate Reestimates ¹	(311)	(339)
Technical and Default Reestimates	(483)	5,199
Subsidy Reestimates	(794)	4,860
Components of Loan Modifications		
Loan Modification Costs	-	7
Modification Adjustment Transfers	-	-
Loan Modifications	-	7
Activity		
Fee Collections	448	473
Loan Cancellations ²	(154)	(100)
Subsidy Allowance Amortization	435	(406)
Other	(390)	(349)
Total Activity	339	(382)
Ending Balance, Allowance for Subsidy	\$ 8,245	\$ 8,405

¹ The interest rate reestimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury.

² Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

Direct Loan Financing Account Interest Expense and Interest Revenue

(Dollars in Millions)	2007	2006
Interest Expense on Treasury Borrowing	\$ 5,675	\$ 6,505
Interest Expense	\$ 5,675	\$ 6,505
Interest Revenue from the Public	\$ 4,859	\$ 4,173
Amortization of Subsidy	(435)	406
Interest Revenue on Uninvested Funds	1,251	1,926
Interest Revenue	\$ 5,675	\$ 6,505

The Direct Loan financing account borrows from Treasury to fund the unsubsidized portion of its lending activities. As required, the Department calculates and pays Treasury interest at the end of each year. Interest is earned on the outstanding Direct Loan portfolio during the year and on its weighted average Fund Balance with Treasury at year-end.

Subsidy amortization is calculated, as required in Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*, as the difference between interest revenue and interest expense. The allowance for subsidy is adjusted with the offset to interest revenue.

Payable to Treasury

(Dollars in Millions)	<u>2007</u>	<u>2006</u>
Future Liquidating Account Collections, Beginning Balance	\$ 4,555	\$ 3,411
Valuation of Pre-1992 Loan Liability and Allowance	288	2,036
Capital Transfers to Treasury	<u>(735)</u>	<u>(892)</u>
Future Liquidating Account Collections, Ending Balance	4,108	4,555
Collections on Guaranty Agency Federal Funds	2	13
Direct Loan Downward Subsidy Re-estimate	498	-
FFEL Downward Subsidy Re-estimate	<u>743</u>	<u>951</u>
Payable to Treasury	<u>\$ 5,351</u>	<u>\$ 5,519</u>

The liquidating account, based on available fund balance each year, liquidates the Fund Balance with Treasury. The FFEL and Direct Loan financing accounts pay the liability related to downward subsidy reestimates upon budget execution.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

(Dollars in Millions)	<u>2007</u>	<u>2006</u>
Beginning Balance, Liability for Loan Guarantees	\$ 52,350	\$ 30,500
Components of Subsidy Transfers		
Interest Supplement Costs	7,580	18,268
Defaults, Net of Recoveries	885	1,665
Fees	(5,052)	(7,859)
Other ¹	2,967	4,264
Current Year Subsidy Transfers	6,380	16,338
Components of Subsidy Reestimates		
Interest Rate Reestimates	1,286	90
Technical and Default Reestimates	(2,782)	9,924
Subsidy Reestimates	(1,496)	10,014
Components of Loan Modifications		
Loan Modification Costs	-	1,710
Modification Adjustment Transfers	-	94
Loan Modifications	-	1,804
Activity		
Interest Supplement Payments	(10,991)	(8,925)
Claim Payments	(5,924)	(4,345)
Fee Collections	4,036	3,799
Interest on Liability Balance	1,616	1,110
Other ²	4,760	2,055
Total Activity	(6,503)	(6,306)
Ending Balance, Liability for Loan Guarantees	50,731	52,350
FFEL Liquidating Account Liability for Loan Guarantees	143	103
Liabilities for Loan Guarantees	\$ 50,874	\$ 52,453

¹ Subsidy primarily associated with debt collections and loan cancellations due to death, disability, and bankruptcy.

² Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

The FFEL liquidating account liability for loan guarantees is included in the total liabilities for loan guarantees as shown in the FFEL Program reconciliation of liabilities.

Subsidy Expense

Direct Loan Program Subsidy Expense		
(Dollars in Millions)	2007	2006
Components of Current Year Subsidy Transfers		
Interest Rate Differential	\$ (846)	\$ (601)
Defaults, Net of Recoveries	422	1,226
Fees	(398)	(403)
Other	1,117	1,566
Current Year Subsidy Transfers	295	1,788
Subsidy Re-estimates	(794)	4,860
Loan Modification Costs	-	7
Direct Loan Subsidy Expense	\$ (499)	\$ 6,655

In the 2007 reestimates, Direct Loan subsidy expense was decreased by \$794 million. Changes in the income-contingent repayment assumption increased subsidy expense by \$1 billion. This increase was more than offset by decreases in subsidy cost related to loan volume of \$(924) million, statutory loan discharges of \$(544) million, interest rates of \$(348) million decreases and other factors. The subsidy rate is sensitive to interest rate fluctuations. For example, a 1 percent increase in projected borrower base rates would reduce projected Direct Loan costs by \$955 million.

In the 2006 reestimates, Direct Loan subsidy expense was increased by \$4.9 billion. Several factors accounted for this increase. Changes in the assumptions for the collections of defaulted loans contributed approximately \$3.3 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) increased subsidy expense by \$1.4 billion. A refinement of the Department's forecast using interest rate scenarios provided by OMB in a probabilistic approach accounted for an increase of \$230 million.

FFEL Program Loan Guarantee Subsidy Expense		
(Dollars in Millions)	2007	2006
Components of Current Year Subsidy Transfers		
Interest Supplement Costs	\$ 7,580	\$ 18,268
Defaults, Net of Recoveries	885	1,665
Fees	(5,052)	(7,859)
Other	2,967	4,264
Current Year Subsidy Transfers	6,380	16,338
Subsidy Reestimates	(1,496)	10,014
Loan Modification Costs	-	1,710
FFEL Loan Guarantee Subsidy Expense	\$ 4,884	\$ 28,062

In the 2007 reestimates, FFEL subsidy expense was decreased by \$1.5 billion. Changes in the federal cost of loan deferments and forbearance increased subsidy expense by \$2.3 billion. This increase was more than offset by changes in subsidy cost related to statutory loan discharges of \$(1.4) billion, loan maturity and repayment rates of \$(1.5) billion, loan volume of \$(890) million

and other factors. The subsidy rate is sensitive to interest rate fluctuations. For example, a 1 percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by \$11.1 billion.

In FY 2007 the Department restated the eligibility requirements specified by the HEA for lenders to receive special allowance payments at the 9.5 percent minimum return rate on loans made or purchased with funds derived from tax exempt obligations issued before October 1993, and implemented certain processes to validate eligibility. Pending obtaining definitive information regarding which loans will continue to qualify to receive such special allowances, it is not possible at this time to determine the potential reduction, if any, in the Department's subsidy estimates.

In the 2006 reestimates, FFEL subsidy expense was increased by \$10.0 billion. Changes in interest rates account for an \$8.9 billion increase in subsidy expense. Of this \$8.9 billion increase, \$6.2 billion is attributed to the change in interest supplement costs associated with higher than originally forecasted loan consolidations that occurred in late FY 2006. In addition, the refinement of the Department's forecasting methodology, as noted above, accounted for an additional \$1.8 billion to the increase in subsidy expense. Other changes in assumptions for variables (such as assumed term and maturity, loan volume, and prepayment rates) decreased subsidy expense by \$700 million on a net basis.

Subsidy Rates

The Subsidy rates applicable to the 2007 loan cohort year were as follows:

Subsidy Rates – Cohort 2007					
	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program	(5.41%)	2.41%	(2.30%)	6.78%	1.48%
	Interest Supplements	Defaults	Fees	Other	Total
FFEL Program	7.45%	0.85%	(5.02%)	3.00%	6.28%

The subsidy rate represents the subsidy expense of the program in relation to the obligations or commitments made during the fiscal year. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department, or when third-party lenders disburse guaranteed loans. These subsidy rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense, nor are these rates applicable to the portfolio as a whole.

The costs of the Department's student loan programs, especially the Direct Loan Program, are highly sensitive to changes in actual and forecasted interest rates. The formulas for determining program interest rates are established by statute; the existing loan portfolio has a mixture of borrower and lender rate formulas. Interest rate projections are based on probabilistic interest rate scenario inputs developed and provided by OMB.

Administrative Expenses

(Dollars in Millions)	2007		2006	
	Direct Loan	FFEL	Direct Loan	FFEL
Operating Expense	\$ 397	\$ 232	\$ 342	\$ 224
Other Expense	16	9	15	8
Administrative Expenses	\$ 413	\$ 241	\$ 357	\$ 232

Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In some statutorily defined cases, funds are provided to schools so that student loans may be cancelled. For certain defaulted loans, the Department reimburses the originating school and collects from the borrowers. These collections are transferred to Treasury. On September 30, 2007 and 2006, loans receivable, net of an allowance for loss, were \$188 million and \$192 million, respectively. These loans are valued at historical cost.

Note 7. Debt

(Dollars in Millions)	2007	2006
Beginning Balance, Debt	\$ 105,430	\$ 104,372
New Borrowing	17,892	33,278
Repayments	(19,429)	(32,220)
Ending Balance, Debt	\$ 103,893	\$ 105,430

The level of repayments on borrowings to Treasury is derived from many factors. For instance, beginning of the year cash balance, collections, and new borrowings have an impact on the available cash to repay Treasury. Also, cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

Note 8. Other Liabilities

(Dollars in Millions)	2007		2006	
	Intragovern- mental	With the Public	Intragovern- mental	With the Public
Other Liabilities				
Liabilities Covered by Budgetary Resources				
Current				
Employer Contributions and Payroll Taxes	\$ 1	\$ -	\$ 1	\$ -
Liability for Deposit Funds	-	8	-	8
Accrued Payroll and Benefits	-	4	-	4
Deferred Credits	-	-	-	1
Contractual Services	-	-	-	39
Total Other Liabilities Covered by Budgetary Resources	1	12	1	52
Liabilities Not Covered by Budgetary Resources				
Current				
Accrued Unfunded Annual Leave	-	7	-	7
Non-current				
Accrued Unfunded FECA Liability	1	-	1	-
Liabilities in Miscellaneous Receipt Accounts	188	-	-	192
Accrued FECA Actuarial Liability	-	4	-	4
Total Other Liabilities Not Covered by Budgetary Resources	189	11	1	203
Other Liabilities	\$ 190	\$ 23	\$ 2	\$ 255

Other liabilities include current and non-current liabilities. The non-current liability primarily consists of the student loan receivables of the Perkins Loan Program, which once collected, will be returned to the General Fund of Treasury.

Liabilities not covered by budgetary resources include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources totaled \$200 million and \$204 million as of September 30, 2007 and 2006, respectively.

Liabilities covered by budgetary resources as of September 30, 2007 and 2006, totaled \$163.0 billion and \$165.9 billion, respectively.

Note 9. Accrued Grant Liability

Federal Student Aid's accrued grant liability was \$1,030 million and \$1,250 million as of September 30, 2007 and 2006, respectively.

Note 10. Net Position**Unexpended Appropriations**

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Unobligated Balances		
Available	\$ 2,496	\$ 3,437
Not Available	659	129
Undelivered Orders	11,265	10,073
Unexpended Appropriations	\$ 14,420	\$ 13,639

Federal Student Aid had Cumulative Results of Operations of \$(2,574) million as of September 30, 2007, and \$(5,152) million as of September 30, 2006. Cumulative Results of Operations consist mostly of net investments of capitalized assets and unfunded expenses, including upward subsidy reestimates for loan programs.

Note 11. Intragovernmental Cost and Exchange Revenue by Program

As required by the *Government Performance and Results Act of 1993*, Federal Student Aid's reporting organization has been aligned with a major goal presented in the U.S. Department of Education's *Strategic Plan 2002—2007*.

Strategic Goal 5, Enhance the Quality of and Access to Postsecondary and Adult Education, is a sharply defined directive that guides divisions to carry out the vision and programmatic mission of Federal Student Aid. The net cost program relating to the strategic goal is the Enhancement of Postsecondary and Adult Education.

The following table presents Federal Student Aid's gross cost and exchange revenue by program for FY 2007 and FY 2006. Gross costs and earned revenue are classified as intragovernmental (exchange transactions between Federal Student Aid and another entity within the Federal government) or with the public (exchange transactions between Federal Student Aid and a non-Federal entity). The Department reclassified FY 2006 FFEL interest expense to conform to FY 2007 presentation.

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Enhancement of Postsecondary and Adult Education		
Intragovernmental Gross Cost	\$ 5,561	\$ 6,747
Gross Costs with the Public	21,858	52,056
Total Program Costs	27,419	58,803
Less: Intragovernmental Earned Revenue	3,487	3,131
Earned Revenue from the Public	4,424	4,641
Total Program Revenue	7,911	7,772
Net Cost of Operations	\$ 19,508	\$ 51,031

Note 12. Interest Expense and Interest Revenue

(Dollars in Millions)	Direct Loan Program		FFEL Program		Total	
	2007	2006	2007	2006	2007	2006
Federal	\$ 5,675	\$ 6,505	\$ -	\$ -	\$ 5,675	\$ 6,505
Non-federal	-	-	1,616	1,110	1,616	1,110
Interest Expense	\$ 5,675	\$ 6,505	\$ 1,616	\$ 1,110	\$ 7,291	\$ 7,615
Federal	\$ 1,251	\$ 1,926	\$ 1,616	\$ 1,110	\$ 2,867	\$ 3,036
Non-federal	4,424	4,579	-	-	4,424	4,579
Interest Revenue	\$ 5,675	\$ 6,505	\$ 1,616	\$ 1,110	\$ 7,291	\$ 7,615

For the Direct Loan Program, federal interest expense is recognized on the Department's outstanding debt. Non-federal interest revenue is earned on the individual loans in the loan portfolio, while federal interest is earned on the uninvested Fund Balance with Treasury. For the FFEL Program, federal interest revenue is earned on the uninvested Fund Balance with Treasury in the financing account. The Department reclassified FY 2006 FFEL program interest expense to conform to the FY 2007 presentation.

Note 13. Statement of Budgetary Resources

The Statement of Budgetary Resources (SBR) compares budgetary resources with the status of those resources. As of September 30, 2007, budgetary resources were \$121,735 million and net outlays were \$30,265 million. As of September 30, 2006, budgetary resources were \$164,339 million and net outlays were \$25,085 million.

Permanent Indefinite Budget Authority

The Direct Loan Program and the FFEL Program have permanent indefinite budget authority through legislation. Part D of the Direct Loan Program and Part B of the FFEL Program, pursuant to the HEA, pertain to the existence, purpose, and availability of this permanent indefinite budget authority.

Reauthorization of Legislation

Funds for most Department programs are authorized, by statute, to be appropriated for a specified number of years, with an automatic one-year extension available under Section 422 of the *General Education Provisions Act*. Congress may continue to appropriate funds after the expiration of the statutory authorization period, effectively reauthorizing the program through the appropriations process. The current *Budget of the United States Government* presumes all programs continue per congressional budgeting rules.

Apportionment Categories of Obligations Incurred

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Direct and Reimbursable:		
Category A	\$ 722	\$ 727
Category B	79,760	112,559
Exempt from Apportionment	12	176
Apportionment Categories of Obligations Incurred	<u>\$ 80,494</u>	<u>\$ 113,462</u>

Category A apportionments are those resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by OMB.

Unused Borrowing Authority

<u>(Dollars in Millions)</u>	<u>2007</u>	<u>2006</u>
Beginning Balance, Unused Borrowing Authority	\$ 7,237	\$ 5,442
Current Year Borrowing Authority	19,570	35,073
Funds Drawn From Treasury	(17,892)	(33,278)
Ending Balance, Unused Borrowing Authority	<u>\$ 8,915</u>	<u>\$ 7,237</u>

Federal Student Aid is given authority to draw funds from Treasury to finance its direct lending activity. Unused Borrowing Authority is a budgetary resource and is available to support obligations. Federal Student Aid periodically reviews its borrowing authority balances in relation to its obligations and may cancel unused amounts.

Undelivered Orders at the End of the Period

<u>(Dollars in Millions)</u>	<u>2007</u>		<u>2006</u>	
	<u>Budgetary</u>	<u>Non- Budgetary</u>	<u>Budgetary</u>	<u>Non- Budgetary</u>
Undelivered Orders	<u>\$ 11,290</u>	<u>\$ 13,908</u>	<u>\$ 10,121</u>	<u>\$ 12,460</u>

Undelivered orders at the end of the year, as presented above, will differ from the undelivered orders included in the Net Position, Unexpended Appropriations. Undelivered orders for federal credit financing and liquidating funds are not funded through appropriations and are not included in Net Position. (See Note 10)

Explanation of Differences Between the Statement of Budgetary Resources and the Budget of the United States Government

Budgetary accounting as shown in the President's Budget includes a public enterprise fund that reflects the gross obligations by the FFEL Program for the estimated activity of the consolidated Federal Funds of the Guaranty Agencies. Ownership by the federal government is independent of the actual control of the assets. Since the actual operation of the Federal Fund is independent from the Department's direct control, budgetary resources and obligations are estimated and disclosed in the President's Budget to approximate the gross activities of the combined federal funds. Amounts reported on the FY 2006 Statement of Budgetary Resources for the Federal Fund are compiled through combining all Guaranty Agencies' Annual Reports to determine a net valuation amount for the Federal Fund.

Note 14. Reconciliation of Net Cost of Operations to Budget

The Reconciliation of Net Cost of Operations (proprietary) to Budget provides information on the total resources used, both those received through budgetary resources and those received through other means during the reporting period. The schedule presented in this footnote reconciles these resources with the net cost of operations by (1) removing resources that do not fund net cost of operations and (2) including components of net cost of operations that did not generate or use resources during the year.

Offsetting Receipts, a component of Resources Used to Finance Activities, include downward reestimates for the Direct Loan and FFEL Programs. OMB Circular No. A-11, revised as of November 2006, requires that downward subsidy reestimates in guaranteed and direct loan programs be paid from the financing accounts to general fund receipt accounts beginning in FY 2007. In FY 2006 and prior years, the downward subsidy reestimates were paid to the related program accounts.

Components Requiring or Generating Resources in Future Periods primarily result from subsidy expense recognized for financial statement reestimate purposes as required by the Statement of Federal Financial Accounting Standards No. 2. Reestimates published in the President's Budget, when executed, generate or require resources.

Reconciliation of Net Cost of Operations to Budget

	2007	2006
Resources Used to Finance Activities		
Obligations Incurred	\$ (80,494)	\$ (113,462)
Spending Authority from Offsetting Collections and Recoveries	43,079	83,785
Offsetting Receipts	4,735	(51)
Imputed Financing from Costs Absorbed by Others	(9)	(8)
Total Resources Used to Finance Activities	(32,689)	(29,736)
Resources Used to Finance Items Not Part of Net Cost of Operations		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided (+/-)	(2,602)	(3,565)
Resources that Fund Expenses Recognized in Prior Period	(3,306)	(2,801)
Credit Program Collections which Increase/Decrease Liabilities for Loan Guarantees, or Credit Program Receivables, Net including Allowances for Subsidy	33,894	73,678
Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in the Current or Prior Period	(39,799)	(48,272)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(11,813)	19,040
Components Not Requiring or Generating Resources		
Depreciation and Amortization	(441)	401
Other (+/-)	907	(94)
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources	466	307
Components Requiring or Generating Resources in Future Periods		
Increase in Annual Leave Liability	(7)	(8)
Upward/Downward Re-estimates of Credit Subsidy Expense	(1,354)	(4,200)
Increase in Exchange Revenue Receivable from the Public	2,302	1,603
Other (+/-)	(39)	43
Total Components of the Net Cost of Operations that Will Require or Generate Resources in Future Periods	902	(2,562)
Net Cost of Operations	\$ (19,508)	\$ (51,031)

Note 15. Contingencies**Guaranty Agencies**

Federal Student Aid can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

Perkins Loan Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In FY 2007, the Department provided funding of 84.3 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.7 percent of program funding. For the latest academic year ended June 30, 2007, approximately 722,003 loans were made, totaling approximately \$1.6 billion at 1,636 institutions, averaging \$2,230 per loan. The Department's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2007.

In FY 2006, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the academic year ended June 30, 2006, approximately 727,546 loans were made, totaling approximately \$1.6 billion at 1,666 institutions, averaging \$2,178 per loan. The Department's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2006.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, in nursing, or in family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances, a contingency is deemed to exist. Federal Student Aid may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness. Payments required under the Perkins Loan partial forgiveness statutes do not have a material effect on Federal Student Aid's financial statements.

Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on Federal Student Aid's financial position.

Other Matters

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures that are subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on Federal Student Aid's financial position.

Note 16. Subsequent Events

The College Cost Reduction and Access Act of 2007 (CCRAA), P.L. 110-84, was passed by Congress, signed by the President, and became effective October 1, 2007. No part of this Act was effective during FY 2007, nor were any budgetary resources provided by Treasury or apportioned by OMB. Consistent with instructions received from OMB regarding the application of OMB Circular No. A-11 and Statement of Federal Financial Accounting Standard No. 2, cost adjustments to the outstanding student loan portfolio incurred as a result of the CCRAA will be apportioned, executed, and recognized in FY 2008.

The CCRAA contains a number of provisions that will affect the cost of outstanding loans and loan guarantees. The modification costs resulting from the Act is estimated to require approximately \$1.5 billion in budget authority based on 2008 President's Budget assumptions. The modification will be recalculated and executed based on updated 2009 budget assumptions in February 2008.

Required Supplementary Information

United States Department of Education
Federal Student Aid
Combining Statement of Budgetary Resources
For the Year Ended September 30, 2007

(Dollars in Millions)

	Combined		Federal Family Education Loan Program	
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources:				
Unobligated balance, brought forward, October 1:	\$ 4,387	\$ 46,490	\$ 823	\$ 40,011
Recoveries of prior year Unpaid Obligations	1,356	3,043	814	432
Budgetary Authority:				
Appropriations	29,484		8,125	
Borrowing Authority		19,570		
Spending authority from offsetting collections (gross):				
Earned				
Collected	1,691	37,019	1,691	16,007
Change in unfilled customer orders				
Without advance from Federal Sources		(30)		
Subtotal	31,175	56,559	9,816	16,007
Nonexpenditure transfers, net	(1)		(1)	
Permanently not available	(1,845)	(19,429)	(1,806)	
Total Budgetary Resources	\$ 35,072	\$ 86,663	\$ 9,646	\$ 56,450
Status of Budgetary Resources:				
Obligations incurred:				
Direct	\$ 30,623	\$ 49,871	\$ 8,350	\$ 23,221
Subtotal	30,623	49,871	8,350	23,221
Unobligated Balances:				
Apportioned	2,504	321	9	321
Subtotal	2,504	321	9	321
Unobligated Balance not available	1,945	36,471	1,287	32,908
Total Status of Budgetary Resources	\$ 35,072	\$ 86,663	\$ 9,646	\$ 56,450
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	\$ 11,584	\$ 12,941	\$ 2,342	\$ 3,532
Uncollected customer payments from Federal Sources, brought forward, October 1		(30)		
Total, unpaid obligated balance, brought forward, net	11,584	12,911	2,342	3,532
Obligations Incurred, net	30,623	49,871	8,350	23,221
Gross Outlays	(28,366)	(45,344)	(7,600)	(22,612)
Recoveries of prior year unpaid obligations, actual	(1,356)	(3,043)	(814)	(432)
Change in uncollected customer payments from Federal Sources		30		
Obligated Balance, net, end of period				
Unpaid Obligations	12,485	14,425	2,278	3,709
Total, unpaid obligated balance, net, end of period	12,485	14,425	2,278	3,709
Net Outlays				
Net Outlays:				
Gross Outlays	28,366	45,344	7,600	22,612
Offsetting collections	(1,691)	(37,019)	(1,691)	(16,007)
Distributed Offsetting receipts	(35)	(4,700)		(3,715)
Net Outlays	\$ 26,640	\$ 3,625	\$ 5,909	\$ 2,890

**United States Department of Education
Federal Student Aid
Combining Statement of Budgetary Resources
For the Year Ended September 30, 2007**

(Dollars in Millions)

	<u>Direct Student Loan Program</u>		<u>Grant Programs*</u>	
	<u>Non-Budgetary Credit Reform Financing Accounts</u>			
	<u>Budgetary</u>	<u>Budgetary</u>	<u>Budgetary</u>	<u>Budgetary</u>
Budgetary Resources:				
Unobligated balance, brought forward, October 1:	\$ 40	\$ 6,479	\$ 3,524	
Recoveries of prior year Unpaid Obligations	27	2,611	515	
Budgetary Authority:				
Appropriations	4,967		16,392	
Borrowing Authority		19,570		
Spending authority from offsetting collections (gross):				
Earned				
Collected		21,012		
Change in unfilled customer orders				
Without advance from Federal Sources		(30)		
Subtotal	4,967	40,552	16,392	
Nonexpenditure transfers, net				
Permanently not available		(19,429)	(39)	
Total Budgetary Resources	\$ 5,034	\$ 30,213	\$ 20,392	
Status of Budgetary Resources:				
Obligations incurred:				
Direct	\$ 4,971	\$ 26,650	\$ 17,302	
Subtotal	4,971	26,650	17,302	
Unobligated Balances:				
Apportioned			2,495	
Subtotal			2,495	
Unobligated Balance not available	63	3,563	595	
Total Status of Budgetary Resources	\$ 5,034	\$ 30,213	\$ 20,392	
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	\$ 516	\$ 9,409	\$ 8,726	
Uncollected customer payments from Federal Sources, brought forward, October 1		(30)		
Total, unpaid obligated balance, brought forward, net	516	9,379	8,726	
Obligations Incurred net	4,971	26,650	17,302	
Gross Outlays	(5,390)	(22,732)	(15,376)	
Recoveries of prior year unpaid obligations, actual	(27)	(2,611)	(515)	
Change in uncollected customer payments from Federal Sources		30		
Obligated Balance, net, end of period				
Unpaid Obligations	70	10,716	10,137	
Total, unpaid obligated balance, net, end of period	70	10,716	10,137	
Net Outlays				
Net Outlays:				
Gross Outlays	5,390	22,732	15,376	
Offsetting collections		(21,012)		
Distributed Offsetting receipts		(985)	(35)	
Net Outlays	\$ 5,390	\$ 735	\$ 15,341	

*Grant Programs Budgetary Only

Required Supplementary Stewardship Information

Investment in Human Capital

Human Capital investments are those expenses included in net cost for general public education and training programs that are intended to increase or maintain national economic productive capacity.

Expenses incurred for human capital investments consisted of the following for FY 2007 and the preceding four years:

Summary of Human Capital Expenses					
(Dollars in Millions)	2007	2006	2005	2004	2003
Federal Student Aid Expense					
Direct Loan Program Subsidy	(\$ 499)	\$ 6,655	\$ 5,211	(\$ 543)	\$ 4,716
Guaranteed Loan Program Subsidy	4,884	28,062	9,863	8,516	2,509
Grant Programs	15,092	15,447	15,070	14,943	13,836
Salaries & Administrative	173	172	164	186	179
Total	\$ 19,650	\$ 50,336	\$ 30,308	\$ 23,102	\$ 21,240

The Direct Loan Program is a direct-lending program in which loan capital is provided to students by the federal government through borrowings from the U.S. Treasury.

The guaranteed program operates with state and private nonprofit guaranty agencies to provide loan guarantees and interest supplements through permanent budget authority on loans by private lenders to eligible students.

Grant programs include the Pell Grant Program that awards direct grants through participating institutions to undergraduate students with financial need. Participating institutions either credit the appropriated funds to the student's school account or pay the student directly once per term. Signed into law in 2006, the ACG and the SMART Programs are available to encourage eligible students to take more challenging courses in high school and to pursue college majors in high demand in the global economy.

Federal Student Aid's programs link with the overall initiatives of the Department in enhancing education – a fundamental stepping-stone to higher living standards for American citizens. While education is vital to national economic growth, 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.

In the past, 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 continue to place 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 investing in postsecondary education.

Office of Inspector General Transmittal Letter



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 15 2007

Larwrence Warder
Acting Chief Operating Officer
Federal Student Aid
Washington, D.C. 20202

Dear Mr. Warder:

The enclosed reports present the results of the annual audits of Federal Student Aid's (FSA) financial statements for fiscal years 2007 and 2006, to comply with the Higher Education Act Amendments of 1998. The reports should be read in conjunction with FSA'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 FSA 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 FSA's financial statements, or conclusions about the effectiveness of internal control, whether FSA'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 white background.

John P. Higgins, Jr.

Enclosures

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

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

Report of Independent Auditors



Ernst & Young LLP
1101 New York Avenue NW
Washington, DC 20005

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of Federal Student Aid (FSA), a performance-based organization 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 FSA'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 FSA'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 FSA'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 FSA 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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Report of Independent Auditors

Page 2

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, and required supplementary 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*. 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 FSA'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 13, 2007

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Report on Internal Control



Ernst & Young LLP
1101 New York Avenue NW
Washington, DC 20005

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization 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 FSA'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 FSA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of FSA'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 FSA'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.

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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.

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.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

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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 and FSA 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 and FSA's knowledge.

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 OCFO, 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 and FSA 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



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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.

- 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.



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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.
- *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 Federal Student Aid 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.



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2. Continue efforts to more fully implement cohort reporting, with specific research on whether balances in the Department's and FSA'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 and FSA 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 and FSA 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.

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 Federal Student Aid perform the following:



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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 FSA'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.

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 and FSA have 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.



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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 and FSA 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 or FSA 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 and FSA require additional focus.



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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 and FSA continue their 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 and FSA.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2006 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

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



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We have reviewed our findings and recommendations with FSA 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 FSA and 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

Report on Compliance with Laws and Regulations



Ernst & Young LLP
1101 New York Avenue NW
Washington, DC 20005

Phone: (202) 327-6000
Fax: (202) 327-6200
www.ey.com

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization 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 FSA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity'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 FSA.

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 FSA'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. FSA relies on the Department's systems to provide support for FSA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instance of noncompliance:

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**Report on Compliance with Laws and Regulations**

Page 2

While the Department and FSA have 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 and FSA 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 or FSA 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 FFMI A relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMI A, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department and FSA. 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 FSA and 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

Management's Response

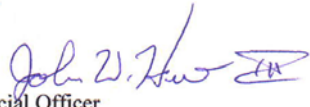


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FEDERAL STUDENT AID

November 9, 2007

MEMORANDUM

TO: John P. Higgins, Jr.
Inspector General

FROM: John W. Hurt, III 
Acting Chief Financial Officer
Federal Student Aid

SUBJECT: DRAFT AUDIT REPORTS
Fiscal Years 2007 and 2006 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17H0004

Federal Student Aid wishes to express our appreciation for the efforts and professionalism of the Office of Inspector General and our auditors, Ernst & Young, LLP, in their audit of our fiscal year 2007 financial statements. We concur with the findings and recommendations as identified in the reports of November 8, 2007.

Federal Student Aid continues to support the Department of Education's efforts to address the significant deficiencies related to the credit reform estimation and financial reporting processes. We recognize that significant additional work remains to be accomplished in order for the Department to have a fully institutionalized practice.

We are committed to maintaining an unqualified opinion in future fiscal years and we will continue to prioritize corrective actions to eliminate significant deficiencies and other matters as noted in the reports. In addition, working with the Department, we will continue to implement additional improvements on controls over information systems.

Once again, we thank the Office of Inspector General and Ernst & Young for their efforts to complete a successful audit of Federal Student Aid's financial statements.

Glossary of Acronyms and Abbreviations

ABC	Activity Based Costing
ACG	Academic Competitiveness Grant
ACSI	American Customer Satisfaction Index
Caucus	Student Loan Ombudsman Caucus
CCRAA	The College Cost Reduction and Access Act of 2007, P.L. 110-84
CDR	National Cohort Default Rate
CLTDR	Cumulative Lifetime Default Rate
COD	Common Origination and Disbursement
COO	Chief Operating Officer
Department	U. S. Department of Education
EDM	Enterprise Data Management
FAFSA	Free Application for Federal Student Aid
FFEL	Federal Family Education Loan
FMFIA	Federal Managers' Financial Integrity Act
FSEOG	Federal Supplemental Educational Opportunity Grant
FWS	Federal Work Study
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GPA	Grade Point Average
HEA	Higher Education Act of 1965
HERA	Higher Education Reauthorization Act
IMC	Investment Management Committee
IPEDS	Integrated Postsecondary Education Data System
IPIA	Improper Payments Information Act of 2002
LaRS	Lender Reporting System
LEAP	Leveraging Educational Assistance Partnership Program
NSLDS	National Student Loan Data System
OCTS	Ombudsman Case Tracking System
OMB	Office of Management and Budget
OPE	Office of Postsecondary Education
OPM	Office of Personnel Management
PAR	Performance and Accountability Report
PBO	Performance Based Organization
Perkins	Federal Perkins Loan Program
PII	Personally Identifiable Information
PMA	President's Management Agenda
SLEAP	Special Leveraging Educational Assistance Partnership Program
SMART	National Science and Mathematics Access to Retain Talent Grant
TPD	Total and Permanent Disability
Treasury	U. S. Department of the Treasury
VDC	Virtual Data Center
Direct Loan	William D. Ford Federal Direct Loan



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