
Student Financial Assistance Enforcement of the Institutional Financial Responsibility Regulations



FINAL AUDIT REPORT

ED-OIG/A09-A0018
September 2001

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U.S. Department of Education
Office of Inspector General
Sacramento, California

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Statements that management practices need improvements, as well as other conclusions and recommendations in this report represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate Department of Education officials.

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UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MEMORANDUM

SEP 28 2001

TO: Greg Woods
Chief Operating Officer
Student Financial Assistance

FROM: *for* 
Lorraine Lewis

SUBJECT: FINAL AUDIT REPORT
*Student Financial Assistance Enforcement of the Institutional Financial
Responsibility Regulations*
Control No. ED-OIG/A09-A0018

Attached is our subject final report that covers the results of our review of the enforcement of the financial responsibility regulations for institutions with fiscal years ended July 1998 through June 1999. Please provide us with your final response to each open recommendation within 60 days of the date of this report indicating what corrective actions you have taken or plan, and related milestones.

In accordance with Office of Management and Budget Circular A-50, we will keep this audit report on the OIG list of unresolved audits until all open issues have been resolved. Any reports unresolved after 180 days from date of issuance will be shown as overdue in the OIG's Semiannual Report to Congress.

Please provide the Supervisor, Post Audit Group, Office of Chief Financial Officer and the Office of Inspector General with quarterly status reports on promised corrective actions until all such actions have been completed or continued follow-up is unnecessary.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us in the review. Should you have any questions concerning this report, please call Gloria Pilotti, Regional Inspector General for Audit at 916-930-2399.

Attachment

Table of Contents

Executive Summary.....	1
Background	3
Audit Results	4
Finding No. 1 – CMO Needs to Improve Its Policies and Procedures to Ensure That Case Teams Take Timely Enforcement Action When Institutions Have a Composite Score of Less Than 1.5	4
Finding No. 2 – DRCC Needs to Improve Its Operations to Ensure That CMO Has Accurate and Timely Information for Making Financial Responsibility Determinations.....	8
Finding No. 3 – DRCC Needs to Make Required Notifications and CMO Needs to Take Enforcement Action When Institutions Fail to Submit Complete Financial Statements	12
Finding No. 4 – DRCC Contract Performance Measures Could Be Enhanced.....	15
Finding No. 5 – CMO Needs to Implement a Well-Designed Monitoring Process for Evaluating Contractor’s Performance.....	17
Finding No. 6 – CMO Needs to Address Weaknesses in Controls Over CAIRO.....	18
Other Matters.....	21
Objective, Scope, and Methodology.....	23
Statement on Management Controls	27
Attachment – SFA’s Comments to the Report.....	28

Executive Summary

The Higher Education Act (HEA) requires the U.S. Department of Education (Department) to determine whether an institution has the financial responsibility to participate in the Title IV programs. To meet the statute, the Department issued regulations establishing standards and provisions that a postsecondary institution must satisfy to demonstrate that it is financially sound enough for students to confidently invest their time and money in programs offered by the institution, and for the Federal government, on behalf of the taxpayer, to provide that institution with access to substantial amounts of public funds.

The Department's Student Financial Assistance (SFA) is responsible for enforcement of institutional financial responsibility requirements. To meet part of its responsibility, SFA contracts with Friday Systems Services, Inc. (Contractor) for operation of the Document Receipt and Control Center (DRCC). DRCC is responsible for receiving institutions' audited financial statements, screening the statements for completeness and acceptability, soliciting missing financial information, calculating the composite scores, and transmitting financial statements requiring action to Case Management and Oversight (CMO) case teams. CMO, located within SFA's Schools Channel, is responsible for monitoring the Contractor's performance, making financial responsibility determinations, and taking any required enforcement action.

When SFA determines that an institution is not financially responsible or has not submitted required audited financial statements, it has the authority to initiate an action to fine the institution, or limit, suspend or terminate the institution's participation in the Title IV programs. SFA may revoke the certification of those institutions that participate under a provisional certification.

To meet the statutory requirement, SFA needs to have controls and procedures in place that ensure it enforces the financial responsibility regulations in a consistent and timely manner. We concluded that SFA had not established sufficient controls and procedures.

- CMO case teams did not always act timely to obtain required letters of credit (LOC) from institutions with composite scores of less than 1.0 and to notify institutions that their continued participation was subject to the zone alternative requirements.
- DRCC did not correctly calculate composite scores, identify all areas to be flagged for further review by CMO, complete reviews of financial statements timely, and deliver flagged financial statements to CMO timely.
- DRCC did not make all required notifications when institutions failed to submit complete financial statements to SFA and CMO case teams did not refer institutions to the Administrative Actions and Appeals Division (AAAD), the office within SFA responsible for initiating fines, limitations, suspensions, and terminations, when institutions failed to submit complete financial statements.
- SFA's contract for operation of the DRCC did not include a performance target for the delivery of flagged financial statements and excluded non-flagged financial statements from the performance target for accurate calculation of composite scores.

- CMO has not implemented a well-designed quality assurance plan for evaluating the Contractor's performance.
- CMO needs to address control weaknesses in Correspondence And Institutional Ratio Analysis Operation (CAIRO) database related to changes to composite score calculations and processing dates.

These weaknesses adversely affect SFA's ability to meet its statutory obligation to ensure that institutions participating in the Title IV programs are financially sound enough to provide their educational programs and to have access to substantial amounts of public funds.

We recommend that the Chief Operating Officer for Student Financial Assistance develop and implement policies, procedures, and contract modifications needed to improve the management controls and procedures relevant to enforcement of the financial responsibility regulations. The AUDIT RESULTS section of the report contains our specific recommendations for each of the findings.

The OTHER MATTERS section of the report provides information on three additional areas that came to our attention during the review regarding use of consolidated financial statements to determine financial responsibility of an institution, incomplete "90/10 revenue" notes in financial statements, and proposed performance incentives for DRCC.

In his comments to the draft report, the Chief Operating Officer concurred with the findings and recommendations and described the corrective action taken or planned. The comments are summarized in the report following each finding and the full text of the comments is included as an attachment.

The Chief Operating Officer stated in his response that it is critical that a postsecondary institution demonstrate that it is financially sound enough for students to invest their time and money in attending the institution. He also stated that it would not always be in the best interest of the students or the public to take an action on an institution's financial statements without the insights provided by other oversight tools (*i.e.*, institutional audits, program reviews, technical assistance visits, and recertification reviews). He stated that SFA sometimes must look beyond the literal requirements of the financial responsibility regulations in order to (1) meet the goals of protecting students and the integrity of the Title IV programs and (2) prevent precipitous school closures.

The Chief Operating Officer's position is not consistent with the HEA or the financial responsibility regulations. SFA does not have the authority to exempt an institution from the financial responsibility requirements based on insights provided by other oversight tools. The HEA requires that "[t]he determination as to whether an institution has met the standards of financial responsibility ... shall be based on an audited and certified financial statement of the institution." Pursuant to 20 U.S.C. § 1232(c), "[a]ll regulations shall be uniformly applied and enforced throughout the 50 States." It is a fundamental requirement of the HEA that institutions must meet the standards of financial responsibility to participate in the Title IV programs. SFA needs to ensure that it enforces the financial responsibility regulations in a consistent and timely manner.

Background

The HEA creates a statutory requirement for institutions to meet financial responsibility standards established by the Department, as demonstrated through the submission of annual financial statement and compliance audits. The standards for determining whether an institution is financially responsible are specified in 34 CFR Part 668, Subpart L. One standard of financial responsibility is that the institution's equity, primary reserve, and net income ratios yield a composite score of at least 1.5. Information provided in an institution's annual audits is used to calculate this composite score and evaluate other financial responsibility standards. Other standards include that the institution has sufficient cash reserves to make required refunds, is current in its debt payments, is meeting all of its financial obligations, has obtained an unqualified opinion on its financial statements, and meets the past performance provisions.¹ An institution that is not financially responsible under these standards may continue to participate in the Title IV programs by qualifying under alternative standards, which include:

- Complying with zone alternative requirements. This option is available to institutions with composite scores from 1.0 to 1.4 for no more than three consecutive years.
- Providing an irrevocable LOC in an amount equal to at least one-half of the Title IV funds received during the institution's most recently completed fiscal year.
- Participating under provisional certification and providing an irrevocable LOC in an amount equal to at least ten percent of the Title IV funds received during the institution's most recently completed fiscal year. This option is limited to no more than three consecutive years.

Public and private non-profit institutions that expend \$300,000 or more in Federal funds during the year are required to have audits conducted in accordance with Office of Management and Budget Circular A-133. Proprietary institutions are required to have audits conducted in accordance with the audit guides developed by the Department's Office of Inspector General (OIG).

SFA's performance plans for fiscal years 1999, 2000, and 2001, which outline its organizational objectives, indicators, and operating goals, did not specifically address processes related to enforcement of the financial responsibility regulations. The plans did not include performance measurements for such organizational responsibilities as ensuring that institutions submit complete financial statements timely, the Contractor meets expected performance levels and CMO takes appropriate enforcement actions timely.

¹ Except for the past performance provision, these standards do not apply to public institutions. An institution is designated as a public institution by the State or other government entity that has jurisdiction over the institution.

Audit Results

We concluded that SFA did not have sufficient controls and procedures to enforce the financial responsibility regulations that were established to ensure that institutions participating in the Title IV programs are financially capable of providing the education they offer.

- SFA's policies and procedures did not ensure that CMO case teams took appropriate and timely enforcement action.
- The Contractor had implemented policies and procedures to ensure that its staff performed the work, but did not always provide accurate information or perform the work timely.
- Neither DRCC nor CMO took sufficient action when institutions failed to submit complete financial statements.
- The DRCC contract defined the work to be performed, but did not include sufficient provisions to ensure that the work was done correctly and timely.
- CMO had not fully implemented a monitoring process to ensure that the Contractor met contract provisions.
- We noted weaknesses in the controls over CAIRO, which is used to document DRCC's review of the financial statements and calculation of the composite score.

We concluded that CMO case teams appropriately evaluated institutional past performance and that CMO financial analysts generally had the appropriate education and/or past work experience for evaluating financial information.

Our review covered the institutional financial statements reviews, composite score calculations, and enforcement actions concerning private non-profit and proprietary institutions with fiscal years ended in the months of July 1998 through June 1999 (sampling universe). For public institutions, we limited our review to CMO case teams' evaluation of the institutions' past performance.

Finding No. 1 – CMO Needs to Improve Its Policies and Procedures to Ensure That Case Teams Take Timely Enforcement Action When Institutions Have a Composite Score of Less Than 1.5

CMO did not take timely action to enforce financial responsibility regulations. We found that CMO case teams did not always (1) require LOCs from institutions with composite scores of less than 1.0 and (2) take timely action to notify institutions that their continued participation in the Title IV programs was subject to the zone alternative requirements.

DRCC flags the financial statements for a financial responsibility determination by a CMO case team when (1) the composite score is less than 1.5, (2) there was a change in auditor, (3) the auditor issued an opinion other than unqualified or (4) the financial statements notes disclosed contingent liabilities, violations of a debt agreement, or compliance or going concern issues. When flagged financial statements are received from DRCC, the assigned case team conducts its own review of the financial statements and may recalculate the institution's composite score. The case team then initiates any enforcement action that it determines is appropriate.

***CMO Case Teams Did Not Always
Act Timely to Obtain Required
Letters of Credit From Institutions
With Composite Scores of Less Than 1.0***

Pursuant to 34 CFR § 668.175, an institution with a composite score of less than 1.0 may continue to participate in the Title IV programs only if the institution meets one of the following alternative standards:

- Provides an irrevocable LOC in an amount equal to at least one-half of the Title IV funds received during the institution's most recently completed fiscal year, or
- Participates under a provisional certification and provides an irrevocable LOC in an amount equal to at least ten percent of the Title IV funds received during the institution's most recently completed fiscal year.

In the preamble to the final regulations, the Department stated its concern regarding institutions with composite scores below 1.0 and stressed the importance of immediate action to obtain an LOC. The Department stated:

... [T]here is considerable uncertainty regarding the ability of the institution [with a composite score below 1.0] to continue operations and satisfy its obligations to students and to the Secretary. For that institution, the Secretary believes that additional oversight and surety are required immediately to protect the Federal interest.²

CMO did not take timely action to obtain LOCs from institutions covered by 7 of the 21 financial statements reviewed in our sample.³ Based on our review of available information, we concluded:

² 62 Fed. Reg. 62,861 (1997).

³ To evaluate LOC enforcement actions taken by CMO case teams, we selected 28 of the 266 financial statements from our sampling universe with composite scores of less than 1.0 in CAIRO (24 randomly selected and 4 judgmentally selected). For 7 of the 28 financial statements, CMO case teams made appropriate and timely decisions that no LOC was required for the institutions. The institutions covered by the remaining 21 financial statements were required to provide an LOC in order to continue their participation in Title IV programs.

- CMO case teams received four of the seven flagged financial statements from DRCC promptly after the due date for submission by the institution, but the case teams took no action to request LOCs from the institutions.
- A CMO case team received another set of flagged financial statements from DRCC about one and one-half months after the due date for submission, but did not request the LOC until three months later and then granted the institution a three-month extension to provide the LOC.
- The remaining two financial statements were not submitted timely by the institutions. (The statements were received by the case team about 9½ and 15 months after the due date for submission.) CMO did not initiate appropriate action to obtain the financial statements earlier and took no action to request LOCs from the institutions when the financial statements were received. As discussed in Finding No. 3 of this report, we concluded that neither DRCC nor CMO made an adequate effort to obtain financial statements timely.

By not taking prompt action when an institution did not demonstrate the required level of financial responsibility, SFA did not provide taxpayers with the protection provided by an LOC and permitted the continued participation of institutions that did not meet the statutory and regulatory requirements for participating in the Title IV programs.

CMO Case Teams Did Not Always Take Timely Action to Notify Institutions That Their Continued Participation Was Subject to the Zone Alternative Requirements

Title 34 CFR § 668.175(d) allows an institution that is not financially responsible solely because of a composite score of 1.0 to 1.4 to continue to participate in the Title IV programs provided that the institution meets the conditions of the zone alternative. In the preamble to the final regulations, the Department stated its concern regarding institutions with composite scores of 1.0 to 1.4.

In view of the limited resources of zone institutions, and the uncertainty regarding the ability of those institutions to continue operations and satisfy their obligations to students and to the Secretary in times of fiscal distress, the Secretary believes it is necessary to monitor more closely the operations of zone institutions, including their administration of title IV, HEA program funds.⁴

CMO case teams did not take timely appropriate action for institutions covered by two of eight financial statements in our sample with composite scores of 1.0 to 1.4.⁵ Our review of DRCC transmittal sheets showed that CMO case teams received the two flagged financial statements

⁴ 62 Fed. Reg. 62,836 (1997).

⁵ To evaluate enforcement action for institutions with composite scores of 1.0 to 1.4, we selected 17 of the 260 financial statements from our sampling universe with composite scores of 1.0 to 1.4 in CAIRO (12 randomly selected and 5 judgmentally selected). CMO case teams made appropriate and timely decisions that 9 of the 17 institutions were not subject to the zone alternative requirements. The institutions covered by the remaining eight financial statements were required to meet zone requirements in order to continue their participation in Title IV programs.

within 21 days of the due date for submission by the institution. One case team sent the notification about six months after DRCC transmitted the flagged financial statements. For the other flagged financial statements, the case team had not taken action to notify the institution as of the time of our review.

Because the case teams did not take appropriate action for zone institutions, the institutions were not subject to the cash monitoring or reimbursement payment requirements. In addition, the institutions were not required to provide timely information regarding certain actions that may adversely affect the institution's ability to satisfy its financial obligations to students and the Department and information on certain financial events that may cause or lead to a deterioration of the institution's financial condition.

Recommendations

The Chief Operating Officer for Student Financial Assistance should develop and implement written policies and procedures that:

- 1.1 Require case teams to promptly proceed with requesting and obtaining LOCs from institutions that have a composite score of less than 1.0.
- 1.2 Require case teams to promptly notify institutions when their continued participation is subject to the requirements of the zone alternative due to a composite score of 1.0 to 1.4.
- 1.3 Require case teams to refer institutions to AAAD for appropriate action under 34 CFR § 668.171(e) when institutions fail to provide LOCs or fail to satisfy the requirements of the zone alternative.

SFA Comments

SFA generally concurred with the recommendations. In his response to our draft report, the Chief Operating Officer described the corrective action taken or planned.

- CMO will emphasize to case teams that they should carefully assess each institution when an LOC is required, establish a target completion date, document decisions made, and expedite closure.

Even though SFA agreed with the recommendation that case teams should take prompt action to request and obtain LOCs and proposed the above corrective action, it maintained that there are acceptable reasons for delays in receiving an LOC. SFA provided the following situations: (1) when a case team is already involved in discussions with the institution over its administration of Title IV funds or its financial viability, (2) the institution is in the re-certification process or (3) a sale of the institution is anticipated.

- For institutions scoring in the zone, SFA instructed case teams to promptly notify the institutions of the zone requirements and monitor their compliance. SFA plans to examine previously issued guidance for possible updating.

- SFA instructed case teams of the procedures to follow in referring institutions to AAAD for appropriate action when the institution fails to satisfy zone alternative requirements.

OIG Response

The corrective action described in SFA's response does not fully address our recommendations.

- The corrective action did not include expected timeframes for case team actions. For example, SFA did not specify the expected maximum elapsed days between the date the case team receives a flagged financial statement and the date it sends a request for an LOC. We do not agree that it is acceptable to delay receipt of LOCs for the reasons listed in SFA's response to our draft report.
- Case teams should be given written instructions. The instructions referred to in the response were verbally communicated during a conference call with the case teams.
- The corrective action for Recommendation 1.3 only discussed AAAD referral procedures for institutions that failed to satisfy the zone alternative requirements. The procedures should also address referrals for institutions that fail to provide LOCs.

Finding No. 2 – DRCC Needs to Improve Its Operations to Ensure That CMO Has Accurate and Timely Information for Making Financial Responsibility Determinations

DRCC did not always provide CMO with accurate and timely information. We found that DRCC did not fully comply with the financial responsibility regulations when calculating composite scores and did not identify all areas needing further CMO review. We also found that DRCC did not complete financial statements reviews timely and promptly deliver flagged financial statements to CMO.

DRCC's Composite Score Calculations Did Not Fully Comply With Financial Responsibility Regulations

Pursuant to 34 CFR § 668.172 the financial information and formulas used in calculating the composite score. Based on these regulations and other applicable guidance, the DRCC analysts enter information from the financial statements into CAIRO. The CAIRO software then performs the composite score calculation based on this information.

DRCC analysts did not fully comply with the regulations or DRCC's written guidance when entering amounts used by CAIRO to calculate the composite score for 12 of the 37 financial

statements reviewed.⁶ Even though the DRCC's written procedures provided for an independent quality control review of all amounts entered by the analyst, the quality control reviewer did not correct the entry errors. Incorrect calculations may allow an institution to continue participating in the Title IV programs without the additional protections for the students and taxpayers provided by the zone alternative or LOC requirements.

DRCC Did Not Identify All Areas Needing Further Review by CMO

DRCC analysts perform a primary screening of the financial statements to confirm that the institution submitted complete and acceptable statements and to identify factors that may impact CMO case teams' financial responsibility determinations. We noted instances where the DRCC analyst did not flag areas specified in the DRCC's screening instructions. Our review identified financial information not listed in the screening instructions that we concluded warranted further review by CMO case teams when making financial responsibility determinations.

Areas Listed in Primary Review Instructions. DRCC analysts did not always flag the financial statements when the notes to the financial statements contained information on contingent liabilities. DRCC's procedures for the primary review instruct analysts to flag the financial statements when the notes to the financial statements disclose contingent liabilities having a material impact on the financial statements. While the notes in the financial statements did not contain estimates of the potential losses, the fact that the disclosures were made indicates that there may be a material impact on the financial statements.

Additional Areas May Warrant CMO Review. We noted information in the financial statements that we reviewed that may warrant further CMO case team review even though the information did not meet the criteria for flagging financial statements. CAIRO does not provide an option for analysts to flag financial statements when they identify additional areas warranting further CMO review. The thoroughness of the primary screening could be improved by providing a method for DRCC analysts to use when they identify other factors that may impact an institution's financial condition. CMO case teams may not make appropriate determinations regarding an institution's financial responsibility when financial statements with information that may potentially impact an institution's financial condition are not referred to CMO for further review.

DRCC Did Not Complete Reviews of Financial Statements and Deliver Flagged Financial Statements to CMO Timely

The elapsed time between DRCC's receipt of the financial statements and delivery of flagged financial statements impacts how effectively SFA enforces the financial responsibility regulations. SFA recognized the importance of elapsed time when it included a performance standard on processing time in the current DRCC contract. The contract's Statement of Work Deliverable VI.3 (6) states that "100 [percent] of the financial statements screened are released

⁶ To evaluate the accuracy of the financial information entered by DRCC analysts, we selected 37 of the 2,955 financial statements from our sampling universe with a composite score of 1.0 or higher in CAIRO (23 randomly selected and 14 judgmentally selected).

from the processing queue not later than 15 calendar days after receipt.” The DRCC contract does not contain a specific timeframe for delivery of flagged financial statements to CMO case teams for further review.

Reviews of Financial Statements. Our analysis of processing dates for 1,855 financial statements found that the elapsed days for 1,048 of the financial statements (56 percent) exceeded the 15-day standard and were an average of 35 days late.⁷ Of the 1,048 financial statements with processing elapsed days in excess of 15 days, there were 75 flagged financial statements needing additional review or action by CMO.

Type of Institution	Processing Time Frames							
	Timely	Days Late				Total	Number Late	Percent Late
		1-15	16-45	46-75	Over 75			
Private Non-Profit	71	100	426	242	39	878	807	92%
Proprietary	736	156	75	5	5	977	241	25%
Total	807	256	501	247	44	1,855	1,048	56%

Delivery of Flagged Financial Statements. DRCC delivers the flagged financial statements to each CMO case team on a weekly basis. DRCC prints a transmittal sheet that lists the flagged financial statements included in each delivery batch. The case team acknowledges receipt of the financial statements by signing and dating the transmittal sheet. Our review of 240 transmittal sheets for reviews completed in January through October 2000 found that DRCC’s deliveries averaged 23 days after the Friday of the week that the DRCC review was completed. The deliveries ranged from 5 to 55 days after the respective end of the week.

Typically, CMO does not take an enforcement action until DRCC has completed its review of the financial statements and provided the case teams with the flagged financial statements. Thus, SFA’s ability to promptly enforce financial responsibility regulations is impacted by the elapsed time taken by DRCC to perform these functions.

Recommendations

The Chief Operating Officer for Student Financial Assistance should:

- 2.1 Require the Contractor to take appropriate corrective action to address the composite score calculation and primary screening errors identified by our review.
- 2.2 Encourage the Contractor to assess its quality review procedures to ensure that the procedures are adequate and consistently followed.
- 2.3 Develop a method for analysts to flag financial statements when they identify additional factors that may impact an institution’s financial condition.

⁷ To evaluate the promptness of DRCC’s reviews, we calculated the elapsed days between the Date Received and Date QC’d in CAIRO for 1,855 financial statements in our sampling universe. Date QC’d is the date that DRCC completed its review of the financial statements. For this analysis, we excluded financial statements reviews with text in the comment field in CAIRO to take into account situations, such as the rejection of incomplete financial statements, that may have impacted DRCC’s ability to complete its review.

- 2.4 Ensure that the Contractor takes corrective action to meet the contract requirement for completion of financial statement reviews within 15 calendar days after receipt.
- 2.5 Develop a standard for timely delivery of flagged financial statements by DRCC and ensure that the Contractor performs to that standard.

SFA Comments

SFA concurred with the recommendations. In his response to the draft report, the Chief Operating Officer described the following corrective action taken or planned:

- CMO will direct the DRCC contractor to revise its draft Quality Control Plan to include (1) detailed tests for reviewing the process for calculating composite scores and (2) a requisite education and skill level for reviewers.
- CMO will develop a process to allow CMO staff and contractor staff to better identify, discuss, and reconcile areas that require interpretation.
- An enhanced system will automate many of the functions currently performed by the contractor and allow the contractor to identify additional factors that may impact a school's financial condition or the reliability of its financial statements.
- CMO will better define and monitor the requirement that the DRCC complete its review of financial statements within 15 days after receipt.
- CMO defined "five working days after the contractor completes its screening and/or analysis" as the expected timeframe for delivery of flagged financial statements to case teams. CMO will modify the current DRCC contract to include this requirement and include the expected timeframe in DRCC's Quality Control Plan.

The Chief Operating Officer agreed with our recommendations regarding timeframes for completion of financial statement reviews and delivery of flagged financial statements, but took exception to the data used to support our conclusions. He stated that the data used in the report was from an atypical period characterized by an exceptionally high volume of work received, staff shortages, and a reorganization. He stated that processing and delivery times have reduced significantly since the reorganization.⁸

OIG Response

The DRCC contractor is required to have a plan for peak period processing. Also, the data represents financial statements received over a 24-month period and deliveries made during a 10-month period.

⁸ The reorganization referred to in the response was the assignment of DRCC analysts to specific CMO case teams.

Finding No. 3 – DRCC Needs to Make Required Notifications and CMO Needs to Take Enforcement Action When Institutions Fail to Submit Complete Financial Statements

Each month, DRCC provides CMO with a report listing the institutions that have not submitted complete financial statements. The report includes both institutions that have not made an initial submission and institutions that have not submitted complete financial statements after rejection of the initial submission. The report is circulated to CMO case teams to solicit additional information regarding the status of the financial statements. If no additional information is received, DRCC sends delinquency letters giving institutions ten business days to submit the required information. CMO is responsible for taking enforcement action when institutions do not submit the required financial statements.

For private non-profit institutions, DRCC receives A-133 audit reports, which include financial statements, from the Federal Audit Clearinghouse. DRCC notifies CMO when it concludes that the financial statements are incomplete. During our audit period, either CMO case teams or DRCC analysts contacted the institution for missing information in the financial statements. According to CMO staff, effective Fall 2000, CMO assumed responsibility for obtaining the missing information by first contacting the Federal Audit Clearinghouse before contacting the institution.

DRCC Did Not Make All Required Notifications When Institutions Failed to Submit Complete Financial Statements

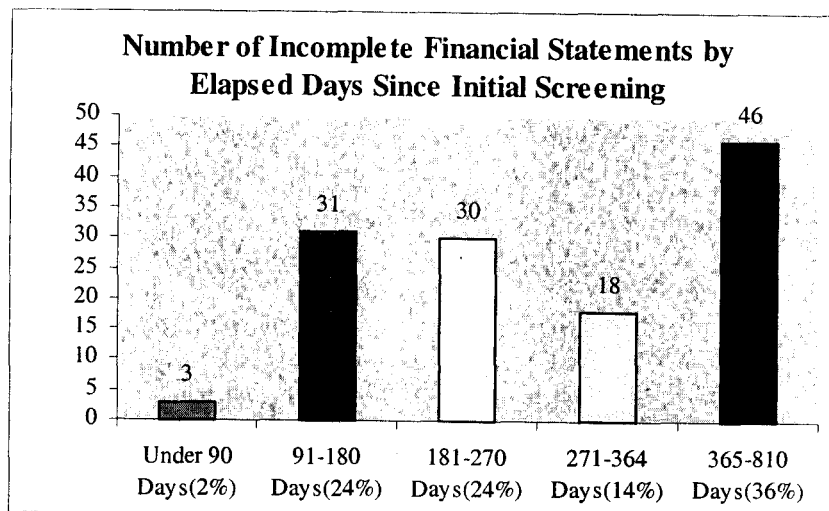
Statement of Work Deliverable VI.3 (4) of the DRCC contract states that “[c]omments are inserted in the Notes Section of the institutional record [in CAIRO] for those financial statements where the Contractor attempted to solicit missing information for incomplete financial statements. Three attempts are required by the Contractor to solicit missing information.”

For the 3,361 financial statements in our sampling universe, we identified 128 financial statements that had an “incomplete” status in CAIRO as of December 22, 2000 (the date that the extract file used in our review was created from CAIRO). To evaluate whether DRCC had made the required three attempts to solicit missing information, we reviewed the comments in CAIRO for ten incomplete financial statements.⁹ We found that DRCC did not make the required three attempts for six of the ten financial statements. For two other financial statements, DRCC did not make the required attempts timely.

We also analyzed the elapsed days between DRCC staff’s initial screening of the financial statements and December 22, 2000. About 36 percent of the financial statements remained

⁹ For this evaluation, we judgmentally selected 12 of the 128 financial statements that had an “incomplete” status in CAIRO. Incomplete financial statements are defined as those missing information, such as the balance sheet, income statement, “90/10 revenue” disclosure or a reference to government auditing standards. We found that the status in CAIRO was incorrect for 2 of the 12 financial statements. The institutions had submitted complete financial statements prior to December 22, 2000.

incomplete for over a year from DRCC's initial screening of the financial statements. The following chart shows the number of financial statements by elapsed day categories.



CMO Case Teams Did Not Refer Institutions to AAAD When Institutions Failed to Submit Complete Financial Statements

When institutions fail to provide complete financial statements and compliance audit reports, the Department can initiate enforcement action.

Title 34 CFR § 668.171(e) states:

If ... the institution does not submit its financial and compliance audits by the date permitted and in the manner required..., the Secretary may —

- (1) Initiate an action ... to fine the institution, or limit, suspend, or terminate the institution's participation in the title IV, HEA programs; or
- (2) For an institution that is provisionally certified, take an action against the institution under the procedures established in § 668.13(d) [revocation of provisional certification].

AAAD is a division within CMO that administers the Department's authority to fine the institution, or limit, suspend, or terminate the institution's participation in the Title IV programs. Nine of the ten institutions with incomplete financial statements did not submit complete statements within a reasonable timeframe. At no time did CMO case teams refer the nine institutions to AAAD for initiation of administrative action.

CMO case teams typically do not initiate any appropriate action until a flagged financial statement is received from DRCC. Thus, any delays in the receipt and processing of the financial statements impact the timing of CMO case team's request for an LOC or initiation of monitoring under the zone alternative requirements. By not promptly notifying AAAD of an institution's failure to provide complete financial statements, SFA may be allowing institutions that are not financially responsible to inappropriately extend their participation in the Title IV programs.

Recommendations

The Chief Operating Officer for Student Financial Assistance should:

- 3.1 Require DRCC to implement corrective action to ensure that it meets its contractual obligation to contact the institutions timely regarding the need to provide complete financial statement information.
- 3.2 Ensure that CMO promptly obtains missing financial information from the Federal Audit Clearinghouse.
- 3.3 Establish procedures that ensure case teams promptly notify AAAD of the need to (1) initiate an action to fine the institution, or limit or suspend or terminate the institution's participation in the Title IV programs when an institution fails to provide required financial information and (2) revoke the certification of those institutions that participate under a provisional certification.

SFA Comments

SFA concurred with the recommendations. In his response to our draft report, the Chief Operating Officer described the corrective action taken or planned.

- The DRCC analyst, who is assigned to the CMO case team providing oversight for the institution, was made responsible for preparing delinquency letters and monitoring contacts with the institution until complete financial statements are received. Also, a weekly report is used to track incomplete financial statements, notification dates are recorded, and the requirement for three attempts is included in DRCC's Quality Control Plan. SFA plans to automate the second and third attempts when an enhanced system replaces the CAIRO system.
- CMO has been contacting the Federal Audit Clearinghouse to obtain information missing from A-133 audit reports.
- CMO reinforced with its case teams the procedures used to refer institutions to AAAD for failing to provide the required audits and updated its written guidance to include the process for determining if complete financial statements had been received.

OIG Response

The corrective action described in SFA's response does not fully address our recommendations. Most of the processes that SFA described were in place at the time of our review (*i.e.*, weekly tracking report, recording of notification dates, the three-attempt requirement in the Quality Control Plan and requesting missing information from the Federal Audit Clearinghouse). We agree that the described actions are helpful in obtaining financial statements and monitoring the timeliness of DRCC's efforts in this area. SFA still needs procedures ensuring that CMO takes appropriate immediate action when the efforts of DRCC and the Federal Audit Clearinghouse have not resulted in the receipt of complete financial statements within an acceptable timeframe.

CMO's reinforcement of AAAD referral procedures during a conference call with the case teams and the updated written guidance did not provide all of the needed corrective action. CMO should also distribute written procedures for referring institution that failed to provide complete financial statements. Second, the updated guidance does not ensure that prompt and appropriate action is taken to obtain complete financial statements.

- The guidance provides for a yearly report to the Federal Audit Clearinghouse listing the public and non-profit institutions that have not submitted A-133 audit reports. A yearly report would not ensure that complete financial statements are received in sufficient time to effectively enforce the financial responsibility regulations. Also, the guidance is silent regarding actions CMO should take when the Federal Audit Clearinghouse efforts are unsuccessful.
- For for-profit institutions, the guidance clearly states that the case teams are responsible for taking appropriate action when DRCC's efforts to obtain complete financial statements are unsuccessful. The guidance provides no specific timeframes for CMO actions. Also, the examples of appropriate action listed in the guidance are not consistent with the enforcement action described in DRCC's letters to the institutions. DRCC's form letter states, "[i]f the Department of Education does not receive a materially complete financial statement by the due date, your institution will be referred to the Administrative Actions and Appeals Division [AAAD] for appropriate administrative action under 34 CFR § 668, Subpart G." The guidance issued by CMO describes several actions that case teams could take, including continued requests for the missing financial information. There is no indication that yet another request would be effective given that (1) Federal regulations require institutions to submit complete financial statements by a specific date, (2) DRCC makes three attempts to obtain the statements, and (3) the institution is informed that it will be referred to AAAD if it fails to provide complete information..

SFA should implement written procedures that require immediate referral to AAAD when attempts by DRCC and the Federal Audit Clearinghouse to obtain complete financial statements are unsuccessful. Additional delay allows institutions continued access to funds in violation of the HEA.

Finding No. 4 – DRCC Contract Performance Measures Could Be Enhanced

SFA could enhance its ability to monitor the DRCC contract by adding a performance measure for delivery of flagged financial statements and expanding the performance measure for accuracy of all composite score calculations. Federal Acquisition Regulation (FAR) § 37.601 states: "Performance-based contracting methods are intended to ensure that required performance quality levels are achieved and that total payment is related to the degree that services performed meet contract standards."

Performance Measure Needed for Delivery of Flagged Financial Statements

The contract's Statement of Work Deliverable VI.3 (6) states that "100 [percent] of the financial statements screened are released from the processing queue not later than 15 calendar days after receipt." Financial statements are considered released from the processing queue when the DRCC analysts have completed their quality control reviews ("Date QC'd"). After completion of the quality control review, DRCC delivers the flagged financial statements to the CMO case teams. The current contract does not specify an expected timeframe for delivery of flagged financial statements to case teams. As we disclosed in Finding No. 2, DRCC did not deliver flagged financial statements promptly after completion of the quality control review. The deliveries averaged 23 days after the end of the week in which DRCC completed its quality control review.

Performance Measure for Accurate Calculations Needs to Apply to Flagged and Non-Flagged Financial Statements

Contract terms require that DRCC performs composite score calculations for all complete and acceptable financial statements submitted by private non-profit and proprietary institutions. Yet, the contract's Statement of Work Deliverable limits the performance level for accurate composite score calculations to the flagged financial statements. Specifically, Statement of Work Deliverable VI.3 (7) states that "95 [percent] of all flagged financial statements are processed accurately through the additional review [composite score calculation] according to the established criteria." Limiting the expected performance level to flagged financial statements provides no assurance that the calculations are performed accurately for complete "non-flagged" financial statements that, based on DRCC analyst inputs, were determined to have composite scores of 1.5 or higher.

Recommendations

The Chief Operating Officer for Student Financial Assistance should work with the appropriate offices within the Department to:

- 4.1 Include in the contract the standard for timely delivery of flagged financial statements to CMO case teams. (See our Recommendation 2.5 regarding development of the standard.)
- 4.2 Expand the expected performance level for accurate composite score calculations to all composite score calculations.

SFA Comments

SFA concurred with the recommendations. SFA plans to modify the DRCC contract to include a timeframe of "five working days" for delivery of flagged financial statements and to include all financial statements in the performance level for accurate calculation of composite scores. SFA also plans to measure adherence to the delivery timeframe by including the requirement in DRCC's Quality Control Plan.

Finding No. 5 – CMO Needs to Implement a Well-Designed Monitoring Process for Evaluating Contractor’s Performance

Monitoring the Contractor’s performance under the DRCC contract is part of SFA’s management control structure for enforcement of the financial responsibility regulations. To meet its monitoring responsibilities, CMO needs to finalize its review of the Contractor’s Quality Control Plan and implement a well-designed Quality Assurance Surveillance Plan.

Review of Contractor’s Quality Control Plan

CMO has not yet finalized its review of the Contractor’s Quality Control Plan. In accordance with the contract provision, the Contractor submitted its Quality Control Plan covering DRCC operations for CMO’s review and comment on March 16, 2000. Attachment A to the plan describes the inspection program that the Contractor planned to use to test its adherence to contract requirements.¹⁰

Contract Statement of Work, Section X states:

The Department will review the Contractor’s draft/original quality control plan within 30 business days after award of the contract. The plan will be returned to the Contractor with the Department’s comments and/or questions. The Contractor shall submit a refined plan to the COTR [Contracting Officer’s Technical Representative] within [ten] business days of receipt. This refined plan shall include any minor revisions of detail within the Contractor’s original submission and answer question(s) posed by the Department.

Implementation of Quality Assurance Surveillance Plan

CMO has not fully implemented the Quality Assurance Surveillance Plan specified in the contract. The plan states that CMO will use at least five methodologies to monitor the Contractor’s performance: statistical random sampling, customer satisfaction surveys, validated complaints, tracking system reports, and 100 percent inspection.¹¹

CMO has implemented some monitoring methodologies. For example, CMO receives various management information reports and CMO case teams may perform a recalculation of the composite score for flagged financial statements. CMO made the Customer Complaint Report Form available to case teams, but the form is not being used. The COTR informed us that he has daily dialogue with DRCC’s Task Manager regarding DRCC operations. CMO has not implemented other monitoring methodologies.

¹⁰ The Contractor also operated the DRCC under the previous contract for the period January 5, 1998 through February 15, 2000. The prior contract required the Contractor to submit a “performance based quality control plan.” The Contractor did not submit such a plan to CMO during the prior contract period.

¹¹ The previous contract for operation of the DRCC also included a Quality Assurance Surveillance Plan. CMO did not fully implement the plan during the prior contract’s period.

The DRCC contract is a time-and-materials contract. FAR § 16.601(b)(1) states that this type of contract provides no positive profit incentive to the Contractor for cost control or labor efficiency. Therefore, appropriate government surveillance of Contractor's performance is required to give reasonable assurance that efficient methods and effective cost controls are being used.

Recommendations

The Chief Operating Officer for Student Financial Assistance should:

- 5.1 Establish prompt and firm dates to finalize the review of the Contractor's quality control plan.
- 5.2 Take immediate steps to fully implement its Quality Assurance Surveillance Plan. If CMO determines that alternative surveillance procedures would be more beneficial, it should appropriately modify the Plan outlined in the contract.

SFA Comments

SFA concurred with the recommendations. CMO plans to approve DRCC's Quality Control Plan by September 30, 2001 and regularly monitor the plan's inspection program.

OIG Response

SFA did not comment on its plans regarding implementation of the Quality Assurance Surveillance Plan described in the DRCC contract. If SFA plans to substitute monitoring of DRCC's inspection program for the Surveillance Plan, SFA should modify the DRCC contract accordingly.

Finding No. 6 – CMO Needs to Address Weaknesses in Controls Over CAIRO

CMO needs to address weaknesses in CAIRO related to changes to composite score calculations and processing dates.

Controls Needed Over Case Team Changes to Composite Score Calculations

When flagged financial statements are received from DRCC, CMO case teams review the financial statements and may perform a recalculation of the composite score. The case teams may conclude that the DRCC analyst entered incorrect or incomplete financial information into CAIRO, which impacted the composite score calculation.

CMO had no written policy or procedures requiring a review of case team determinations that DRCC analysts incorrectly entered financial information for the composite score calculation. We noted instances where the CMO case team member's conclusion was subjected to supervisory review prior to informing the DRCC analyst, such as when a less experienced financial analyst coordinated decisions with the team's lead financial analyst or where the area case director was copied on electronic mail. Yet, there was no requirement for supervisory review and approval.

Although CMO established Sharepost (an electronic mailbox) for the case teams to use to inform DRCC analysts of needed change in amounts entered for the composite score calculation, the case teams were not required to use it. Sometimes the case teams informed the DRCC analyst verbally, either by phone or personal visit, or by personal electronic mail. These types of communication do not provide for proper documentation. We also found that the case teams did not always notify the DRCC of needed changes to the composite score calculation and, as a result, the composite score information in CAIRO remained incorrect.

The General Accounting Office's *Standards for Internal Control in the Federal Government* (GAO's Internal Control Standards)¹² describes the minimum level of quality acceptable for internal control in government and provides the basis against which internal control is to be evaluated. The standards list the accurate and timely recording of transactions and events as a control activity. Another listed control activity is the proper execution of transactions and events, that is, transactions and other significant events are authorized and executed only by persons acting within the scope of their authority. A centralized process for the approval and documentation of changes to financial information in CAIRO would enhance the level of assurance that the changes are appropriate and recorded in CAIRO.

Controls Needed Over Processing Dates

We identified four date fields in CAIRO that document the timely receipt and processing of financial statements and calculation of composite scores:

- Date Received – the date DRCC initially received the financial statements for processing.
- Date Screened – the date that the DRCC analyst initiated the primary screening of the financial statements.
- Date Reviewed – the date that the DRCC analyst entered the financial information for computation of the composite score.
- Date QC'd – the date that a second DRCC analyst performed a quality control review.

Only the Date Screened is both system-generated and not editable. The CAIRO software generates the Date Received and Date Reviewed and the analyst manually enters the Date QC'd. These three dates can be modified by anyone (except those designated as "readers") who has password access to CAIRO.

Dates manually entered are more prone to data input errors (e.g., transpositions, incorrect date). The processing dates are used to evaluate the Contractor's performance. Thus, dates that are manually entered and editable are vulnerable to improper entries or subsequent changes. As mentioned in the prior section, a control activity in GAO's Internal Control Standards is the accurate and timely recording of transactions and events. Dates generated by the application

¹² U.S. General Accounting Office publication GAO/AIMD-00-21.3.1, issued November 1999.

software that are recorded in non-editable fields would enhance the level of assurance that the processing dates are accurate and recorded timely.

Recommendations

The Chief Operating Officer for Student Financial Assistance should:

- 6.1 Implement a centralized process for approval and documentation of changes to financial information in CAIRO.
- 6.2 Modify the CAIRO software application to use a system-generated, non-editable, date field for Date QC'd and non-editable date fields for Date Received and Date Reviewed.

SFA Comments

SFA concurred with the recommendations. SFA plans to develop formal procedures for making changes to financial information and implement system-generated, non-editable date fields.

Other Matters

Use of Consolidated Financial Statements. CMO used consolidated financial statements to determine the financial responsibility of the institutions that were subsidiaries of the parent company. For 65 financial statements reviewed during our audit, consolidated financial statements¹³ were submitted for nine companies having multiple program participation agreements (PPAs) with the Department. For institutions covered by two of the nine consolidated financial statements, an institution-level official (president of the educational institution) signed the institution's PPA. Since an official of the parent company did not sign the PPAs for these institutions, the financial resources of the parent, which CMO used to evaluate financial responsibility, may not be available to meet the liabilities of the institutions.

While Federal regulations do not specify the level of financial statements to be used in making financial responsibility determinations, SFA could ensure that the financial resources of the parent company are available by requiring parent-level co-signers on the PPA, or requiring another type of legally binding document from the parent company, when institutions submit consolidated financial statements to meet the financial responsibility requirements.

In the comments to the draft report, SFA stated that current CMO policy allows case teams to obtain parent-level co-signers on the PPA or seek other financial assurances. We suggest that SFA require CMO to take such action.

Incomplete "90/10 Revenue" Disclosures. DRCC did not always reject the financial statements and instruct institutions to resubmit corrected financial statements when the notes to the financial statements did not contain all required "90/10 revenue" information. Title 34 CFR § 668.23 requires that a proprietary institution disclose in a footnote to its audited financial statements the percentage (including the figures used to make the calculation) of its revenues derived from the Title IV funds received during the fiscal year covered by that audit. A proprietary institution is not eligible for participation in the Title IV programs if it receives more than 90 percent of its revenues from Title IV sources.

Although the "90/10 revenue" financial statement footnote disclosure is not a financial responsibility requirement, the contract requires DRCC analysts to confirm that the disclosure is present in the notes to the financial statements. During the primary screening of financial statements, DRCC analysts confirm that the notes to the financial statements contain the required "90/10 revenue" information. When the "90/10 revenue" note is missing or incomplete, DRCC sends a letter notifying the institution that the financial statements are incomplete and instructs the institution to resubmit corrected financial statements. The DRCC analyst that performed the quality control reviews also did not identify the deficiencies in the "90/10 revenue" information.

The Department's assurance that the institution met the eligibility requirement is diminished when the numbers used in the percentage calculations are not disclosed. Also, the Department

¹³ Consolidated financial statements disregard the distinction between separate legal entities and treat the parent and subsidiary companies as a single economic entity.

has no assurance that institutions included in the financial statements met the eligibility requirements without separate revenue percentages disclosed for each Office of Postsecondary Education identification number.

In the comments to the draft report, SFA stated that DRCC's Quality Control Plan will assess whether financial statements are properly screened for compliance with the 90/10 Rule.

Proposed Performance Incentives. At the time of our fieldwork, CMO was developing performance incentives that it planned to add to the DRCC contract. The Contractor, in conjunction with CMO staff, had developed two documents that described the proposed incentives: *Incentives Program Tests* (current draft is dated October 18, 2000) and *Formula for Computing Incentive For DRCC Contract* (dated October 10, 2000). These documents do not contain elements needed for an effective quality assurance and/or incentive program as required by the FAR.

On May 2, 2001, we issued SFA Action Memorandum No. 01-04 alerting SFA that the proposed incentives did not contain elements needed for an effective incentives program and recommended that SFA suspend CMO's plans to modify the DRCC contract until an effective incentives program is developed that complies with the FAR. In its response dated June 1, 2001, SFA concurred with our recommendation.

In the comments to the draft report, SFA stated that CMO informed the DRCC contractor that the incentive program would not be implemented in the contract at this time. CMO's current goal is to implement an incentives program, which is consistent with the FAR, in the third quarter of fiscal year 2002.

Objective, Scope, and Methodology

The objective of the audit was to determine whether SFA had established sufficient controls and procedures to enforce the financial responsibility regulations contained in 34 CFR Part 668, Subpart L. Specifically, we determined whether:

- The DRCC contract adequately defined the task to be performed and contained provisions to ensure task completion.
- The Contractor had implemented policies and procedures that ensured contract provisions were met and that CMO was provided with timely and accurate information on institutional financial responsibility.
- CMO monitored the Contractor's on-going performance to ensure that contract provisions were met.
- CMO had qualified staff, policies, and procedures to ensure that enforcement action was taken to comply with the financial responsibility regulations.

Our review covered the current DRCC contract that became effective on February 16, 2000, the Contractor's current policies and procedures for operating the DRCC, CMO staff's monitoring of the DRCC contract and CMO's current policies and procedures related to enforcement of the financial responsibility regulations.

We gained an understanding of applicable Federal regulations and the DRCC contract, interviewed various DRCC and CMO managers and staff and reviewed written policies and procedures, including the Contractor's technical proposal and guidance issued from CMO's Performance Improvement and Procedures Office. We reviewed the Federal Manager's Financial Integrity Act Report for fiscal year 2000 and previously issued OIG audit reports covering CMO operations. The OIG issued an audit report titled "Case Management and Oversight's Audit Tracking and Resolution Process" in September 2000 (Control No. ED-OIG/A03-90003). An objective of that audit was to determine whether CMO had established and implemented procedures which provided reasonable assurance that all required annual financial statements and compliance reports were submitted when due. Since CMO's procedures for obtaining initial receipt of financial statements were included in the prior OIG audit, we did not include an assessment of those procedures in the scope of this review.

To achieve the audit objectives, we extensively relied on computer-processed data contained in CAIRO. Our review of system general and application controls identified control weaknesses and the results of data tests identified a data entry error rate for financial information that casts doubt on the data's validity. However, when these data are viewed in context with other available evidence, we believe the opinions, conclusions, and recommendations in this report are valid.

From CAIRO, we randomly selected samples of private non-profit and proprietary institutions' financial statements with fiscal years ended July 1998 through June 1999 (sampling universe).¹⁴ We also judgmentally selected additional financial statements from the sampling universe based on various criteria.

Sampling Universe and Samples				
	Sampling Universe	Random Samples	Judgmental Samples	Total Sampled
Complete financial statements with:				
Composite score of 1.5 or higher	2,695	11	9	20
Composite score from 1.0 to 1.4	260	12	5	17
Composite score of less than 1.0	266	24	4	28
Complete financial statements with no score	12	-	-	-
Incomplete financial statements	128	-	-	-
Total financial statements	3,361	47	18	65

For the institutions covered by the sampled financial statements, we generated reports from CAIRO that showed the primary screening results and amounts used for the composite score calculation, obtained Case Reports from the Case Management Information System and printed selected screens from the Postsecondary Education Participants System. As noted in the following paragraphs, we used the sampled private non-profit and proprietary institutions' financial statements and related reports to perform various tests of DRCC's procedures and CMO's actions that effected enforcement of the financial responsibility regulations.

From the National Student Loan Data System, we randomly selected 29 institutions from the 2,026 public institutions that were eligible and certified to participate in the Title IV programs in September 2000. For public institutions, we limited our review of the enforcement of financial responsibility regulations to the CMO case teams' evaluation of institutions' past performance.

DRCC contract provisions. We compared the financial responsibility requirements with the tasks defined in the current contract to determine which regulatory requirements were included in the contract. We evaluated the quality assurance provisions to assess CMO's ability to rely on the Contractor's work including provisions for staff qualifications, supervision, contract oversight, and ensuring the timeliness and accuracy of work performed.

Contractor's operation of the DRCC. We evaluated management controls including requirements to document work performed by DRCC's staff, provisions for supervisory review, plans for peak period processing, and provisions for technical assistance in resolving accounting issues. We evaluated the qualifications of staff performing the financial reviews through interview and review of position descriptions and staff training information.

For 37 complete financial statements with composite scores of 1.0 or higher, we reviewed DRCC's primary screening and composite score inputs. We also recalculated DRCC's computation of the composite scores that did not fully comply with the financial responsibility regulations.

¹⁴ The sampling universe may not have included financial statements for all institutions that are required to submit audited financial statements. OIG audit (ED-OIG/A03-90003, issued September 2000) reported that CMO did not have a system in place to ensure that public and private non-profit institutions that participate in Title IV programs submit their required annual audited financial statements.

To evaluate the timeliness of DRCC's financial statement review process, we calculated DRCC's processing time for 1,855 financial statements from the time DRCC received the financial statements to the time DRCC completed its quality control review of the statements. Of the 3,361 financial statements in our sampling universe, we excluded from our analysis 1,486 financial statements with text in the comment field in CAIRO to adjust for situations where the review process was delayed because incomplete financial statements were received. We also excluded 20 financial statements that had no composite scores, blank date fields or inconsistent dates in CAIRO.

We also tested DRCC's timeliness of delivery of flagged financial statements to CMO case teams for further review and disposition. We reviewed 240 transmittal sheets for all reviews completed in January through October 2000. The ten-month span was used to average out the peak and slower processing periods. Each transmittal sheet was addressed to a specific case team and generally included reviews for multiple financial statements. We calculated the number of elapsed days from the end of the week during which the quality control review was completed to the signed receipt date on the transmittal sheet.

For the 128 financial statements identified as incomplete in CAIRO, we analyzed the length of time they had been in "incomplete" status. We reviewed 10 incomplete financial statements to evaluate DRCC's staff's actions in obtaining complete information and to determine whether CMO case teams referred institutions to AAAD for not submitting the required complete financial statements.

CMO monitoring of Contractor's performance. We interviewed the COTR to obtain the current monitoring procedures and to discuss training requirements for the COTR position. We reviewed the Contractor's *Quality Control Plan*, which had been submitted in accordance with contract requirements, and CMO's *Quality Assurance Surveillance Plan*, which was specified in the contract. We evaluated the draft *Incentives Program Tests and Formula for Computing Incentive For DRCC Contract* for effectiveness and compliance with FAR requirements.

CMO enforcement actions. We evaluated management controls for ensuring that proper and timely enforcement action is taken to comply with the financial responsibility regulations. We also evaluated the qualifications of staff performing financial analysis through interview and review of position descriptions and staff training information.

For 28 of 266 complete financial statements with composite scores less than 1.0, we reviewed CMO case teams' actions taken to obtain LOCs to determine whether the actions were timely, appropriate, and included provisions for on-going monitoring. When LOCs had been obtained, we evaluated them for correctness of amount and effective dates.

For 17 of 260 complete financial statements with composite scores from 1.0 to 1.4, we reviewed CMO case teams' actions to notify institutions that their continued participation was subject to the zone alternative requirements for timeliness and propriety.

To evaluate CMO case teams' review of past performance, we judgmentally selected ten institutions from our random sample of public institutions and our random sample of complete private non-profit and proprietary financial statements with composite scores of 1.0 or higher. We judgmentally selected the institutions that had most recently completed the re-certification process.

For institutions that submitted the nine consolidated financial statements included in our samples, we reviewed the signature on the institution's Title IV PPA to evaluate the potential impact of the use of consolidated financial statements for making financial responsibility determinations.

We performed our fieldwork in Washington, D.C. at CMO headquarters and the DRCC. Fieldwork was conducted from August 2000 to April 2001. The exit conference was conducted at the SFA office in Washington, D.C. on April 24, 2001. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

Statement on Management Controls

We assessed SFA's system of management controls, policies, procedures, and practices applicable to CMO's enforcement of the financial responsibility regulations, the Contractor's meeting its contractual obligations and CMO's monitoring of the Contractor's performance.

For the purpose of this report, we categorized the significant controls as follows:

- CMO's controls related to enforcement of the financial responsibility regulations, including controls to ensure that case teams take enforcement action for institutions with composite scores of less than 1.5 and for institutions that fail to submit complete financial statements, that institutions are appropriately evaluated for compliance with past performance provisions, that the appropriate level of financial statements is used for financial responsibility determinations, and that changes to composite score calculations are properly authorized and executed.
- The Contractor's controls for meeting its contractual obligations, including controls to ensure the accuracy of financial statements' information entered into CAIRO for the composite score calculation, the accuracy of the screening for factors requiring further CMO review, the timely completion of its reviews, and that required notifications are made for institutions that failed to submit complete financial statements. We also assessed controls to ensure the timely delivery of flagged financial statements to CMO.
- CMO's controls for monitoring the Contractor's performance, including controls to ensure that the contract contained provisions ensuring contractor performance and that a well-designed quality assurance plan was in effect. We also assessed controls to ensure the reliability of data in CAIRO, including software controls and controls over access to the database.

Because of inherent limitations, a study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed significant management control weaknesses, which adversely effected SFA's ability to enforce the financial responsibility regulations. These weaknesses included a lack of timely action taken by CMO when institutions had a composite score of less than 1.5 and when institutions failed to submit complete financial statements. The Contractor needs to improve its procedures for entering information for the composite score calculation, screening financial statements for factors requiring further CMO review, completing its reviews and deliveries timely, and making required notifications when institutions fail to submit complete financial statements. CMO's monitoring efforts could be improved by including performance targets in the contract, implementing a well-designed quality assurance plan, and addressing control weaknesses in CAIRO. These weaknesses and their impacts are discussed in the AUDIT RESULTS section of this report.

SFA's Comments to the Report

OIG Note

SFA's comments to the report include comments on Recommendations 1.4 and 3.4, which are not included in the final report. Although no longer formalized as report recommendations, we suggest that SFA consider expanding its performance plan improvement project list to include measurable operating goals for the Schools Channel to ensure that the financial responsibility regulations are enforced in a consistent and timely manner. Such operating goals would contribute to SFA's stated indicator: improve the financial integrity of the student financial aid program.

**UNITED STATES DEPARTMENT OF EDUCATION**

*Student Financial Assistance
Chief Operating Officer*

AUG 2 2001

Ms. Gloria Pilotti
Regional Inspector General for Audit
U.S. Department of Education
Office of Inspector General
501 I Street, Suite 9-200
Sacramento, CA 95814

Dear Ms. Pilotti:

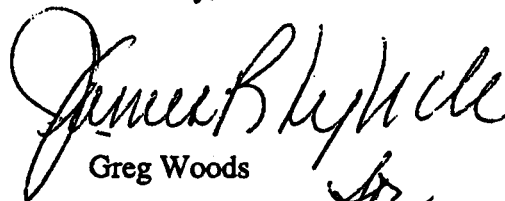

Thank you for the opportunity to review and comment on the draft audit report presenting the results of your audit of *Student Financial Assistance Enforcement of the Institutional Financial Responsibility Regulations*, Control Number ED-OIG/A09-A0018, issued June 2001.

We are pleased that you found the evaluation of institutional past performance by Case Management and Oversight (CMO) to be appropriate. We are also pleased that the audit found the educational and previous work backgrounds of CMO's financial analysts to be appropriate and sufficient for the evaluations of financial information that they are expected to perform. We agree with your conclusions that our procedures and controls to enforce the financial responsibility regulations could be improved, particularly in the areas of workflow processing.

As you indicated in your report, it is critical that a postsecondary institution demonstrate that it is financially sound enough for students to invest their time and money in attending that institution. We feel, however, that taking an action on an institution's financial statements without the insights provided by other oversight tools, such as reviewing institutional audits, conducting program reviews and technical assistance visits, and performing recertification reviews, would not always be in the best interests of the students or the public. Our goals in the financial arena are to protect students and the integrity of the student financial assistance programs, and to prevent precipitous school closures. In order to meet these goals, we sometimes must look beyond the literal requirements of the financial responsibility regulations.

The enclosure provides our response to each recommendation. Again, we appreciate the opportunity to review and comment on the draft report.

Sincerely,


Greg Woods


Page 2 – Ms. Gloria Pilotti

Enclosure

**cc: Patrick Howard
Candy Kane
Jim Lynch
Kay Jacks
Victoria Edwards
Faye Harris**

Response to OIG Draft Audit Report, *Student Financial Assistance Enforcement of the Institutional Financial Responsibility Regulations*, Control Number ED-OIG/A09-A0018, June 2001.

Finding 1:

CMO needs to improve its policies and procedures to ensure that case teams take timely enforcement action when institutions have a composite score of less than 1.5.

Recommendation 1.1: *Require case teams to promptly proceed with requesting and obtaining LOCs from institutions that have a composite score of less than 1.0.*

Response: We generally agree with this recommendation, though there are certain instances in which we feel that there are acceptable reasons for a delay (because of the complexity of the issue) in receiving a letter of credit (LOC) from a failing institution. For example, we believe it is reasonable to accept some delay when a case team is already having discussions with the institution over its administration of Title IV funds or its financial viability, or the institution is in the re-certification process, or a sale is anticipated. However, CMO will emphasize to case teams that they should carefully assess each institution when an LOC is required, establish a target completion date, document decisions made, and expedite closure of these cases.

Recommendation 1.2: *Require case teams to promptly notify institutions when their continued participation is subject to the requirements of the zone alternative due to a composite score of 1.0 to 1.4.*

Response: We concur with this recommendation and we will examine previously issued guidance and update accordingly, if further instruction is needed. Case teams have been instructed that institutions that score in the zone are to be notified of the zone requirements promptly and monitored for compliance.

Recommendation 1.3: *Require case teams to refer institutions to AAAD for appropriate action under 34 CFR § 668.171(e) when institutions fail to provide LOCs or fail to satisfy the requirements of the zone alternative.*

Response: We concur with this recommendation. Case teams were instructed on July 18, 2001, of the procedures to follow in referring institutions to AAAD for appropriate action for failing to satisfy the zone alternative requirements.

Recommendation 1.4: *Implement a performance measure for the Schools Channel to evaluate the timeliness of CMO case team actions to obtain LOCs and subject institutions to zone alternative requirements.*

Response: We do not concur with this recommendation. CMO is responsible for enforcing all the regulations relating to institutional administration of Title IV funds, yet the Schools Channel does not have specific performance measures for all them. Nonetheless, we will examine the feasibility of developing a case team report to monitor these cases to ensure they are resolved expeditiously.

Page 2 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

Finding 2:

DRCC needs to improve its operations to ensure that CMO has accurate and timely information for making financial responsibility determinations.

Recommendation 2.1: *Require the Contractor to take appropriate corrective action to address the composite score calculation and primary screening errors identified by our review.*

Response: We concur with this recommendation. CMO will direct the Document Receipt and Control Center (DRCC) contractor to revise the Quality Control Plan, which is currently in draft form, to include detailed test procedures to review the process for calculating composite scores and also will require as part of those procedures a requisite education and skill level for reviewers. The Quality Control Plan will be finalized by September 30, 2001.

Recommendation 2.2: *Encourage the Contractor to assess its quality review procedures to ensure that the procedures are adequate and consistently followed.*

Response: We concur with this recommendation. The contractor has already submitted a draft Quality Control Plan that is designed to establish adequate and consistent procedures for review. SFA will approve the plan by September 30, 2001, and will monitor the implementation of the plan to ensure the procedures are adequate and consistently followed. See our response to recommendation 5.2.

Recommendation 2.3: *Develop a method for analysts to flag financial statements when they identify additional factors that may impact an institution's financial condition.*

Response: We concur with this recommendation. DRCC's financial analysts need flexibility in the review process to identify conditions that are outside the predefined screening criteria which may, in the judgment of the contractor, impact a school's financial condition or the reliability of its financial statements. To do this, the contractor must have a way to clearly articulate and formally alert CMO of its concerns. In addition, the Data Management and Analysis Division (DMAD) will be implementing a formal process with Performance Improvement and Procedures (PIP) to allow CMO (DMAD and PIP) and contractor staff to better identify, discuss and reconcile areas that require interpretation by August 31, 2001.

Currently, the contractor uses the Lotus Notes Database software to flag financial statements. However, this system will migrate to an enhanced system in the next several months. The enhanced system will automate many of the functions currently performed by the contractor and will allow the contractor to identify "additional factors" that may impact a school's financial condition or the reliability of its financial statement. However, in order to make the change to allow for "additional factors" while also avoiding duplicated costs, any additional changes not already identified for the enhanced system will be part of the Department's modernization plan to create an enhanced data storage operating system.

Page 3 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

Recommendation 2.4: *Ensure that the Contractor takes corrective action to meet the contract requirement for completion of financial statement reviews within 15 days after receipt.*

Response: We concur with this recommendation and will take corrective action to better define and monitor expected performance requirements when the Quality Control Plan is finalized by September 30, 2001.

Recommendation 2.5: *Develop a standard for timely delivery of flagged financial statements by DRCC and ensure that the Contractor performs to that standard.*

Response: We concur with this recommendation. However, we do not believe the data used in the draft audit report for this recommendation and for recommendation 2.4 accurately reflects day-to-day performance because the period reviewed was during a peak period for receipt of financial statements. The processing times and deliveries cited for these two recommendations resulted from a temporary condition that existed when the Department received an exceptionally high number of financial statements in a very short period of time (about one week). The problem was further compounded by staff shortages and a planned re-organization that took place during the period examined. Since the re-organization, the processing time and the delivery of the financial statements to the case teams has been significantly reduced.

In re-evaluating the existing DRCC delivery process, CMO has defined a timeframe of 5 working days after the contractor completes its screening and/or analysis to deliver flagged financial statements to the case teams. CMO will modify the current contract by September 30, 2001, to include this timeframe as a requirement and also will incorporate the timeframe into the Quality Control Plan as a control to measure the effectiveness of contractor performance in this area.

Finding 3:

DRCC needs to make required notifications and CMO needs to take enforcement action when institutions fail to submit complete financial statements.

Recommendation 3.1: *Require DRCC to implement corrective action to ensure that it meets its contractual obligation to contact the institutions timely regarding the need to provide complete financial statement information.*

Response: We concur with this recommendation. The contractor took action to fix this problem in a re-organization that took place in October 2000. After the re-organization, the DRCC's financial analysts were assigned to case teams. Incomplete contacts are now the responsibility of a DRCC financial analyst and it is that analyst's responsibility to prepare letters and monitor contact with institutions until a complete financial statement is received. Incomplete statements are filed at the analyst's desk until final resolution. A weekly report tracks all incomplete financial statements.

Additionally, a three-notification requirement is included in the latest draft of the Quality Control Plan, which will be finalized by September 30, 2001. Records are updated to indicate the dates

Page 4 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

that notifications are sent from the analyst to the institution. The new enhanced system will automatically generate second and third notifications to institutions, which will eliminate notifications not being made.

Recommendation 3.2: *Ensure that CMO promptly obtains missing financial information from the Federal Audit Clearinghouse.*

Response: We concur with this recommendation. Since the Fall of 2000, we have been contacting the Federal Audit Clearinghouse when the A-133 audits they have sent to CMO are missing financial portions. The Clearinghouse then obtains the missing information and provides it to DMAD.

Recommendation 3.3: *Establish procedures that ensure case teams promptly notify AAAD of the need to (1) initiate an action to fine the institution, or limit, suspend, or terminate the institution's participation in the Title IV programs when an institution fails to provide required financial information and (2) revoke the certification of those institutions that participate under a provisional certification.*

Response: We concur with this recommendation. The procedures to refer institutions to the Administrative Actions and Appeals Division (AAAD) for failing to provide required audits were reinforced on July 18, 2001. In addition, in February 2001, PIP updated guidance previously issued to the case teams to include the process for determining if complete financial statements had been received.

Recommendation 3.4: *Implement a performance measure for the Schools Channel to evaluate the timeliness of private non-profit and proprietary institutions' submission of complete financial statements.*

Response: We do not concur with this recommendation. Our Schools Channel performance measures are organizational goals that all offices are working towards, not necessarily the specific tasks of the individual offices. However, because we consider the timely submission of complete financial statements to be important, we will include a performance measure in the DRCC contract to ensure that complete statements are obtained within the timeframes established in the contract.

Finding 4:**DRCC Contract Performance Targets Could Be Enhanced**

Recommendation 4.1: *Include in the contract the standard for timely delivery of flagged financial statements to CMO case teams. (See Recommendation 2.5 regarding development of this standard.)*

Response: We concur with this recommendation. As we stated in our response to recommendation 2.5, the contractor will have a timeframe of 5 working days after it completes its screening and/or analysis to deliver flagged financial statements to the case teams. This

Page 5 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

timeframe will be included as a requirement when the current contract is modified by September 30, 2001, and will be incorporated into the Quality Control Plan as a control to measure the effectiveness of the contractor's performance in timely delivering flagged financial statements.

Recommendation 4.2: *Expand the expected performance level for accurate composite score calculations to all composite score calculations.*

Response: We concur with this recommendation. CMO will modify the current contract by September 30, 2001, to specify that the contractor must accurately calculate the composite scores for 95% of all financial statements received.

Finding 5:

CMO needs to implement a well-designed monitoring process for evaluating contractor's performance.

Recommendation 5.1: *Establish prompt and firm dates to finalize the review of the Contractor's quality control plan.*

Response: We concur with this recommendation. As stated previously, CMO has received a draft Quality Control Plan from the contractor for approval. CMO will ensure that a final plan is approved by September 30, 2001.

Recommendation 5.2: *Take immediate steps to fully implement the Quality Assurance Surveillance Plan. If CMO determines that alternative surveillance procedures would be more beneficial, it should appropriately modify the Plan outlined in the contract.*

Response: We concur with this recommendation. As soon as the Quality Control Plan is approved, CMO will monitor implementation of the inspection program on a biweekly basis for the first two months and will direct the contractor to make any necessary changes to the plan. After such time, CMO will monitor the inspection program monthly for a three-month period, revising the plan accordingly. CMO will then provide for routine monitoring of the inspection program, which is defined in the draft plan as quarterly.

Finding 6:

CMO needs to address weaknesses in controls over CAIRO.

Recommendation 6.1: *Implement a centralized process for approval and documentation of changes to financial information in CAIRO.*

Response: We concur with this recommendation. The contractor will develop formal procedures to provide criteria to allow the contractor to make a change in the financial information, to justify why a change is necessary, and to document the change and reasoning in the data system of record.

Page 6 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

Recommendation 6.2: *Modify the CAIRO software application to use a system-generated, non-editable date field for Date QC'd and non-editable date fields for Date Received and Date Reviewed.*

Response: We concur with this recommendation. The contractor has a plan to update the software to use system-generated dates for the fields noted by the OIG. However, as noted in recommendation 2.3, the current system will migrate to an enhanced operating system in the next several months. This enhanced system will have a Financial Statements module that CMO and contractor staff will use as the system of record instead of the existing system. The system development staff has completed the software programming to include the module and beta tested the software. CMO had already required that the recommended date fields would be system generated and non-editable in the upcoming enhanced system. To avoid duplicate costs, CMO directed the contractor not to expend any funds implementing changes to the upcoming enhanced operating system. Any additional changes will be incorporated when the modernization plan is implemented sometime in 2003.

Other Matters:

Use of Consolidated Financial Statements: *SFA could ensure that the financial resources of the parent company are available by requiring parent-level co-signers on the PPA, or requiring another type of legally binding document from the parent company when institutions submit consolidated financial statements to meet the financial responsibility requirements.*

Response: Our current policy already allows for obtaining parent-level co-signers. Case teams obtain parent-level co-signers on the Program Participation Agreement (PPA), or seek other financial assurances, when appropriate.

Incomplete "90/10" Revenue Disclosures: *DRCC did not always reject the financial statements and instruct institutions to resubmit corrected financial statements when the notes to the financial statements did not contain all required "90/10 revenue" information.*

Response: We agree that DRCC did not consistently screen financial statements for strict adherence to the 90/10 Rule reporting requirements. We believe this happened because of confusion in the Higher Education Community and in the case teams concerning the calculation and the enforcement of this rule. However, all proprietary institutions and first year not-for-profit institutions are required to meet the 90/10 Rule, formerly the 85/15 Rule, as contained in 34 CFR 600.5(a)(8). The Quality Control Plan should reduce inconsistencies because all financial statement will be screened for compliance with the 90/10 Rule.

Proposed Performance Incentives: *"Incentives Program Tests (draft-October 18, 2000)" and "Formula for Computing Incentive for DRCC Contract (October 10, 2000)" do not contain elements needed for an effective quality assurance and/or incentive program as required by the FAR.*

Response: We agree and CMO has informed the contractor that the incentives program will not be implemented in the contract at this time. CMO will direct the contractor to remove any reference to the incentives program from the Quality Control Plan. In addition, CMO will

Page 7 – Response to OIG Draft Audit Report – ED-OIG/A09-A0018

consult with the Contracts division to determine if any modifications to the contract are necessary to implement an effective incentives program and, if so, modify the contract accordingly. In addition, CMO will research the Federal Acquisition Regulation (FAR) and develop an incentives program that is consistent with all the requirements regarding performance-based contracts. Also, CMO will ensure the incentives program is written in a manner to motivate the contractor at a reasonable cost to the government. Our goal is to implement an incentives program in the third quarter of FY 2002, based on the Quality Control Plan results.

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