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FINANCIAL MANAGEMENT

Financial Management Challenges Remain at the Department of Education

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss (1) the Department of Education's current financial management status as evidenced by its fiscal year 1999 financial audit results[1] and the corrective actions it has taken to resolve weaknesses identified in that audit and (2) the relationship between the audit findings and the potential for waste, fraud, and abuse. Much of the testimony today reflects my May 24, 2000, testimony on these issues.[2]

The Department's financial activity is important to the federal government because Education is the primary agency responsible for overseeing the more than $75 billion annual federal investment in support of educational programs for U.S. citizens and eligible noncitizens. The Department is also responsible for collecting about $175 billion owed by students. In fiscal year 1999, more than 8.1 million students received over $53 billion in federal student financial aid through programs administered by Education.

The Department's stewardship over these assets has been under question as the agency has experienced persistent financial management weaknesses. Beginning with its first agencywide financial audit effort in fiscal year 1995,[3] Education's auditors have each year reported largely the same serious internal control weaknesses, which have affected the Department's ability to provide reliable financial information to decisionmakers both inside and outside the agency.

Background

Federal decisionmakers need reliable and timely financial management information to ensure adequate accountability, manage for results, and make timely and well-informed decisions. However, historically, such financial management information has not been available across the government. Agency Inspector General (IG) reports, independent public accountants' reports, and our own work have identified persistent limitations in the availability of quality financial data for decision-making. Audits have shown that federal financial management is in serious disrepair, which results in incorrect financial information being provided

[1]Department of Education, *Fiscal Year 1999 Consolidated Financial Statements*, Ernst & Young LLP, February 2000.

[2]*Financial Management: Education's Financial Management Problems Persist* (GAO/T-AIMD-00-180, May 24, 2000).

[3]For fiscal year 1995, a year before the Government Management Reform Act (GMRA) requirements became effective, the Department's Inspector General (IG) hired a contractor to perform its first agencywide financial audit.

to the Congress and the administration. Without reliable financial information, government leaders do not have the full facts necessary to make investments of scarce resources or direct programs. Creating a government that runs more efficiently and effectively has been a public concern for decades.

Over the past 10 years, dramatic changes have occurred in federal financial management in response to the most comprehensive management reform legislation of the past 40 years. The combination of reforms ushered in by (1) the Chief Financial Officers (CFO) Act of 1990, (2) the Government Management Reform Act of 1994, (3) the Federal Financial Management Improvement Act (FFMIA) of 1996, (4) the Government Performance and Results Act (GPRA) of 1993, and (5) the Clinger-Cohen Act of 1996 will, if successfully implemented, provide the necessary foundation to run an effective, results-oriented government. Efforts to continue to build the foundation for generating accurate financial information through lasting financial management reform are essential. Only by generating reliable and useful information can the government ensure adequate accountability to taxpayers, manage for results, and help decisionmakers make timely, well-informed judgments.

Education's fiscal year 1999 audit was conducted by Ernst & Young LLP, independent auditors contracted for by the Education Inspector General. We reviewed the independent auditors' reports and workpapers. We also interviewed Education officials to obtain the status of corrective actions and reviewed available corrective action plans. We shared a draft of this statement with Education officials, who provided technical comments. We have incorporated their comments where appropriate. Our work was conducted in accordance with generally accepted government auditing standards.

Fiscal Year 1999 Audit Results

The Office of Management and Budget's (OMB) implementation guidance for audited financial statements requires the 24 CFO Act agencies to receive three reports from their auditors annually: (1) an opinion or report on the agencies' financial statements, (2) a report on the agencies' internal controls, and (3) a report on the agencies' compliance with laws and regulations. As of August 2000, 15 of the 24 CFO Act agencies had received "clean" or unqualified opinions on their fiscal year 1999 financial statements. The Department of Education did not receive such an opinion because of its financial management weaknesses.

Report on the Financial Statements

While Education's financial staff and its contractors worked very hard to prepare Education's fiscal year 1999 financial statements before the March 1, 2000, deadline, and the auditors' opinion on the financial statements improved over that of fiscal year 1998, serious internal control and financial management systems weaknesses continued to plague the agency. For fiscal year 1999, Education made significant efforts to work around these weaknesses and produce financial statements. These efforts enabled its auditors to issue qualified opinions[4] on four of its five required financial statements and a disclaimer on the fifth statement. Its auditors' qualified opinion states that except for the effect of the matters to which the qualification relates, the financial statements present fairly, in all material respects, financial position, net costs, changes in net position, and budgetary resources in conformity with generally accepted accounting principles. The auditors stated the following reasons or matters for their qualification:

- The Department had significant systems weaknesses during fiscal year 1999 affecting its financial management systems. The new accounting system, implemented in fiscal year 1998, had several limitations, including an inability to perform a year-end closing process or produce automated consolidated financial statements. Through its efforts and those of its contractors, Education was able to partially compensate for, but did not correct, certain aspects of the material weaknesses in its financial reporting process. In addition, during fiscal year 1999, Education experienced significant turnover of financial management staff, which also contributed to the overall weakness in financial reporting.

- Education was unable to provide adequate support for about $800 million reported in the September 30, 1999, net position balance in its financial statements, and the auditors were unable to perform other audit procedures to satisfy themselves that this amount was correct.

- Education processed many transactions from prior fiscal years as fiscal year 1999 transactions and manually adjusted its records in an effort to reflect the transactions in the proper period; however, the auditors could not determine if these adjustments for certain costs and obligations were correct.

[4]Such an opinion is expressed when (1) there is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion or (2) the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion.

- The auditors were unable to determine whether beginning balances for accounts payable and related accruals were accurate.

In addition, the auditors did not issue an opinion (referred to as a disclaimer of an opinion) on the Department's Statement of Financing. The Statement of Financing provides a reconciliation or "translation" from the budget to the financial statements. The statement is intended to help those who work with the budget to understand the financial statements and the cost information they provide. The auditors stated that the reason for this disclaimer was that the Department did not perform adequate reconciliations and present support for amounts on the Statement of Financing in a timely manner.

To the extent that Education was able to improve the opinion it received on its financial statements for fiscal year 1999, it was generally the result of (1) time-consuming manual procedures, (2) various automated tools to "work around" the system's inability to close the books and generate financial statements, and (3) reliance on external consultants to assist in the preparation of additional reconciliations and the financial statements. This approach does not produce the timely and reliable financial and performance information Education needs for decision-making on an ongoing basis, which is the desired result of the CFO Act.

Report on Internal Controls

The Department also receives annually from its auditors a report on internal controls. This report is significant for highlighting the agency's internal control weaknesses that increase its risk of mismanagement that can sometimes result in waste, fraud, and abuse. In this report for fiscal year 1999, the Department's auditors reported four material[5] internal control weaknesses—three continuing from fiscal year 1998 and one additional one for fiscal year 1999—and that long-standing internal control weaknesses persist.

The specific material internal control weaknesses cited by the independent auditors for fiscal year 1999 were (1) weaknesses in the

[5]A material internal control weakness is a reportable condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements or material noncompliance with applicable laws or regulations will be prevented or detected on a timely basis. In addition to these material internal control weaknesses, the independent auditors also reported four reportable conditions. Reportable conditions are matters coming to the auditors' attention that, in their judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect the organization's ability to meet the objectives of reliable financial reporting and compliance with applicable laws and regulations.

financial reporting process, (2) inadequate reconciliations of financial accounting records, and (3) inadequate controls over information systems. The independent auditors also identified a new material internal control weakness related to accounting for certain loan transactions. Summaries of the material internal control weaknesses follow:

- Education did not have adequate internal controls over its financial reporting process. Its general ledger system was not able to perform an automated year-end closing process and directly produce consolidated financial statements as would normally be expected from such systems. Because of these weaknesses, Education had to resort to a costly, labor-intensive, and time-consuming process involving manual and automated procedures to prepare financial statements for fiscal year 1999. In addition, Education had to rely heavily on contractor services to help perform reconciliations among the various data sources used. In one instance, Education reported a balance of approximately $7.5 billion for its cumulative results of operations. However, the majority of this amount, which pertains to the Federal Family Education Loan Program (FFELP), should have been reported as a payable to Treasury rather than as cumulative results of operations. As a result of the independent auditors' work, an adjustment was made to reclassify the $7.5 billion to the proper account. When such errors occur and are not detected by the Department's controls, there are increased risks that the Department could retain funds inappropriately that should be returned to Treasury.

  In response to the auditors' findings, Education officials told us that they have developed an implementation plan for the replacement of the general ledger system. The officials further stated that Education had purchased a new general ledger system and completed all the planned corrective actions in response to the auditors' recommendations related to financial reporting weaknesses. However, this new general ledger system will not be fully implemented for fiscal year 2000, and Education will continue to work around the system to produce consolidated financial statements. Education officials said that the Department plans to fully implement the new general ledger system by August 2001 and to eliminate the current general ledger system by January 2002. To facilitate the fiscal year 2000 consolidated audit, Education officials told us they prepared and analyzed interim financial statements as of March 31, 2000, and June 30, 2000.

- Education again did not properly or promptly reconcile its financial accounting records during fiscal year 1999 and could not provide sufficient documentation to support some of its financial transactions. Weaknesses in the Department's internal controls over the reconciliation process prevented timely detection and correction of errors in its underlying accounting records. In some instances, Education adjusted its general ledger to reflect the balance per the subsidiary records, without sufficiently researching the cause for differences. Also, as indicated in prior audits, Education has not been able to identify and resolve differences between its accounting records and cash transactions reported by the Treasury. For example, for fiscal year 1999, Education adjusted its Fund Balance with Treasury, due to a difference between its general ledger and the Treasury, by a net amount of about $244 million. Reconciling agencies' accounting records with relevant Treasury records is required by Treasury policy and is analogous to individuals reconciling their checkbooks to monthly bank statements. In another instance, as we recently reported,[6] Education used its grantback account as a suspense account beginning in 1993 for hundreds of millions of dollars of activity related to grant reconciliation efforts. We also reported that Education did not maintain adequate detailed records for certain grantback account activity by the applicable fiscal year and appropriation. In addition, Education used the grantback account to clear unreconciled differences in various grant appropriation fund balance accounts and adjust certain appropriation fund balances to ensure that they did not become negative.

In response to the auditors' findings, Education has purchased a software tool to help enhance its ability to reconcile its account balances with the corresponding Treasury account balances on a monthly basis. Education has also developed web-based policies and procedures for reconciling the Department's material accounts and programs.

During fiscal year 1999, Education did not properly account for its funds disbursed under FFELP. Specifically, it did not return about $2.7 billion in net collections specific to its liquidating account to Treasury as required by the Credit Reform Act of 1990. The liquidating account is used to record transactions for loans originated prior to fiscal year 1992. Any unobligated balances in this account at fiscal year end are unavailable for obligations in subsequent fiscal years and must be transferred to the general fund. Further, Education did not sufficiently analyze the balances reflected on the financial statements to ensure that the FFELP balances agreed with relevant balances in the Department's budgetary accounts. The auditors stated that this situation resulted in an unexplained difference of about $700 million between the FFELP Fund Balance with Treasury account and related budgetary accounts as of September 30, 1999. By not properly accounting for and analyzing its FFELP transactions as required by the

[6] *Financial Management: Review of Education's Grantback Account* (GAO/AIMD-00-228 August 18, 2000).

Federal Credit Reform Act of 1990, Education could not be assured that its financial or budgetary reports were accurate.

Education returned the $2.7 billion to the Treasury in February 2000. The Department also established policies and procedures to ensure compliance with the Credit Reform Act.

- Education had information systems control deficiencies in (1) implementing user management controls, such as procedures for requesting, authorizing, and revalidating access to computing resources, (2) monitoring and reviewing access to sensitive computer resources, (3) documenting the approach and methodology for the design and maintenance of its information technology architecture, and (4) developing and testing a comprehensive disaster recovery plan to ensure the continuity of critical system operations in the event of disaster. The Department places significant reliance on its financial management systems to perform basic functions, such as making payments to grantees and maintaining budget controls. Consequently, continued weaknesses in information systems controls increase the risk of unauthorized access or disruption in services and make Education's sensitive grant and loan data vulnerable to inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, which could occur without being detected.

  According to Education officials, the Department has developed and implemented a formal approach and methodology for designing and maintaining an entity-wide security program technology architecture and has updated its security policies and procedures for its financial management system to ensure that changing system security needs are reflected, access authorizations are documented, and access rights are revalidated periodically. The Department has developed a disaster recovery plan for Education's Central Automated Processing System (EDCAPS), the accounting system implemented by the Department in fiscal year 1998.

Our work in this area has shown that other agencies have improved their financial audit report results but are also facing material internal control weaknesses. A number of other agencies have focused their efforts primarily on trying to develop short-term stop-gap measures designed to produce year-end balances rather than on the fundamental solutions that are needed to address the management challenges they face. As a result, these agencies continue to experience pervasive material weaknesses in the design and operation of their financial management and related operational systems, accounting procedures, documentation, recordkeeping, and internal controls, including computer security controls. Consequently, these agencies rely on costly, time-consuming ad hoc procedures to determine year-end balances. This approach does not produce the timely and reliable financial and performance information needed for decision-making on an ongoing basis. This approach is also inherently incapable of addressing the underlying financial management and operational issues that adversely affect these agencies' ability to fulfill their missions.

Report on Compliance With Laws and Regulations

The third report that the auditors issue annually is a report on agency compliance with laws and regulations. Specifically, the Department's auditors reported that it was not in full compliance with three laws as noted below.

- For fiscal year 1999, the independent auditors found that Education was not in compliance with FFMIA because it lacked adequate, integrated financial management systems, reports, and oversight to prepare timely and accurate financial statements. Many agencies have significant financial management systems weaknesses, and, in fiscal year 1999, 21 of 24 agencies' systems did not comply with FFMIA. However, it is imperative that these problems be resolved so that agencies can produce needed financial information on a day-to-day basis in a timely and accurate manner. FFMIA requires that agency financial management systems substantially comply with (1) federal financial management systems requirements,[7] (2) federal accounting standards, and (3) the *U.S. Government Standard General Ledger*[8] at the transaction level.
- The Department had neither fully implemented a capital planning and investment process nor performed an assessment of the information resource management knowledge and skills of agency personnel, including a plan to correct identified deficiencies, as required by the Clinger-Cohen Act of 1996. A key goal of the Clinger-Cohen Act is that agencies should have processes and information in place to help ensure that information technology (IT) projects are being implemented at acceptable costs and within reasonable and expected time frames and that they are contributing to tangible, observable improvements in mission performance. By not fully implementing the plans called for under the act, Education was not

[7]The financial management systems requirements have been developed by the Joint Financial Management Improvement Program, which is a joint and cooperative undertaking of the Department of the Treasury, OMB, GAO, and the Office of Personnel Management.

[8]The *Standard General Ledger* provides a standard chart of accounts and standardized transactions that agencies are to use in all their financial systems.

maximizing the value and assessing and managing the risks of its IT investments.

Education officials told us that the Department has since established an Investment Review Board that assesses information technology investments.

- The Department did not transfer its excess funds related to FFELP, specifically the $2.7 billion of net collections previously mentioned, to Treasury as required by the Federal Credit Reform Act of 1990.

  Education officials stated that they believe the noncompliance with the Credit Reform Act issue will be resolved for the fiscal year 2000 audit because they have developed and implemented policies and procedures to respond to this issue.

Potential for Fraud, Waste, and Abuse

Education continues to have serious internal control and system deficiencies that hinder its ability to achieve lasting financial management improvements. The internal control weaknesses discussed above and in more detail in the auditors' report need to be addressed to reduce the potential for waste, fraud, and abuse in the Department. Some of the vulnerabilities identified in the audit report include weaknesses in the financial reporting process, inadequate reconciliations of financial accounting records, information systems weaknesses, and property management weaknesses. Specific examples of vulnerabilities related to these weaknesses follow:

- The material internal control weakness related to financial reporting highlights the fact that managers do not receive accurate and timely financial information, such as information on disbursements made and amounts collected, that could be used to identify unusual activity and other anomalies.
- Some of the known duplicate payments mentioned by the auditors in their report on internal controls could have been identified earlier if proper reconciliations had been performed. The auditors stated that the Department has procedures in place that should detect duplicate payments and correct them within a reasonable time frame. We have not reviewed these procedures.
- The auditors stated that because the Department has not developed formal policies and procedures to reconcile grant expenditures between its payments system and its general ledger system, there is increased risk that material errors or irregularities could occur and not be detected on a

timely basis. This is significant because the volume of grant transactions is over $30 billion per year.

In response to this issue, Education has developed policies and procedures to reconcile grant expenditures to the general ledger.

- The information systems weaknesses highlight some of the computer security vulnerabilities, such as the lack of an effective process to monitor security violations on all critical systems of the Department. Information systems control weaknesses increase the risk of unauthorized access or disruption in services and make Education's sensitive grant and loan data vulnerable to inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, which could occur without being detected. A report issued by the Department's Inspector General in February[9] emphasizes the need for the Department to focus on addressing its computer security vulnerabilities. In addition, earlier this year, the White House recognized the importance of strengthening the nation's defenses against threats to public and private sector information systems that are critical to the country's economic and social welfare when it issued its *National Plan for Information Systems Protection*.[10] In the aftermath of the recent attack by the "ILOVEYOU" virus, which disrupted operations at large corporations, governments, and media organizations worldwide, we recently testified[11] about the need for federal agencies to promptly implement a comprehensive set of security controls. We also recently reported[12]on the results of information security audits at federal agencies that show that federal computer systems are riddled with weaknesses that continue to put critical operations and assets at risk. These types of concerns led us, in 1997 and 1999 reports to the Congress, to identify information security as a high-risk issue.[13]

[9]*Review of Security Posture, Policies and Plans* (ED-OIG/A11-90013) February 2000.

[10]*Defending America's Cyberspace: National Plan for Information Systems Protection: Version 1.0: An Invitation to a Dialogue,* released January 7, 2000, the White House.

[11]*Critical Infrastructure Protection: "ILOVEYOU" Computer Virus Highlights Need for Improved Alert and Coordination Capabilities (GAO/T-AIMD-00-181, May 18, 2000) and Information Security: "ILOVEYOU" Computer Virus Emphasizes Critical Need for Agency and Governmentwide Improvements* (GAO/T-AIMD-00-171, May 10, 2000).

[12]*Computer Security: Critical Federal Operations and Assets Remain at Risk* (GAO/T-AIMD-00-314, September 11, 2000) and *Information Security: Serious and Widespread Weaknesses Persist at Federal Agencies* (GAO/AIMD-00-295, September 6, 2000).

[13]*High- Risk Series: Information Management and Technology* (GAO/HR-97-9, February 1, 1997) and *High-Risk Series: An Update* (GAO/HR-99-1, January 1999).

In response to the IG's February report, Education's Chief Information Officer has developed a corrective action plan to address these weaknesses. This plan proposes developing security plans for the 6 mission-critical systems that did not have them. Education envisions that the plans will meet the requirements of OMB Circular A-130 and the Computer Security Act of 1987. The plan also calls for establishing requirements for security training and a monitoring process to ensure that security personnel receive adequate training. We did not evaluate the effectiveness of these corrective actions.

- The auditors reported that Education had not taken a complete, comprehensive physical inventory of property and equipment for at least the past 2 years. Comprehensive inventories improve accountability for safeguarding the government's assets, such as computer software and hardware, and establish accurate property records. Without such an inventory, property or equipment could be stolen or lost without detection or resources could be wasted by purchasing duplicate equipment already on hand. An alleged equipment theft is currently under investigation by the OIG and the Department of Justice.

In addition, vulnerabilities in the Department's student financial assistance programs have led us since 1990 to designate this a high-risk area[14] for waste, fraud, abuse, and mismanagement. As we reported in our high-risk series update in January 1999, our audits as well as those by the Department's IG have found instances in which students fraudulently obtained grants and loans.

In response to your request, we are auditing selected Education accounts that are deemed particularly susceptible to improper payments based on a risk assessment that takes into account previous findings by GAO, the IG, and Education's independent public accountants. This work is in the initial planning phase and is expected to focus primarily on the Department's disbursement processes and EDP controls. We plan on using various electronic auditing techniques to determine whether the Department has inappropriately disbursed funds. We also plan to evaluate the vulnerability of the Department's EDP systems to fraud, misuse, and disruption.

In summary, Education needs to be able to generate reliable, useful, and timely information on an ongoing basis to ensure adequate accountability to taxpayers, manage for results, and help decisionmakers make timely,

[14] *High-Risk Series: An Update* (GAO/HR-99-1, January 1999).

well-informed judgments. While Education has planned and begun implementing many actions to resolve its financial management problems, it is too early to tell whether they will be successful. It is critical that Education rise to the challenges posed by its financial management weaknesses because its success in achieving all aspects of its strategic objectives depends in part upon reliable financial management information and effective internal controls. It is also important to recognize that several of the financial management issues that have been raised in reports emanating from reviews of Education's financial statements directly or indirectly affect Education's ability to meet its obligations to its loan and grant recipients and responsibilities under law.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other Members of the Subcommittee may have.

Contact and Acknowledgments

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