

Testimony of Lorraine Lewis
Inspector General, U.S. Department of Education
Before the
Subcommittee on Oversight and Investigations
Committee on Education and the Workforce
U.S. House of Representatives

December 6, 1999

Good morning Mr. Chairman and members of the subcommittee. I am pleased to testify before the Subcommittee on Oversight and Investigations, Committee on Education and the Workforce on matters relating to the Department of Education's consolidated financial statements for fiscal year 1998 and related financial issues. Accompanying me today is Steven A. McNamara, Assistant Inspector General for Audit Services. Also testifying today is Michael F. Lampley, a partner with Ernst & Young LLP (E&Y). As you know, E&Y is under contract to the Office of Inspector General (OIG) for the fiscal year 1998 and 1999 financial statement audits.

The OIG has elected to exercise its responsibility for conducting the engagement by contracting with E&Y, an independent public accounting firm. Under this contract, the OIG provided oversight of E&Y's performance of audit procedures and preparation of reports. E&Y provided the OIG with independent reports on the Department's FY 1998 financial statements.

My comprehensive testimony will include a discussion of the following areas:

- Fiscal Year 1998 Results of the Engagement,
- Comparison of FY 1998 with Previous Years,
- Financial Management Practices,
- Recommendation for Improvement, and
- Monitoring Implementation of Recommendations.

We all share a common goal of good government and serving the taxpayer. That includes performing our respective functions to the best of our ability. Fulfilling our stewardship responsibilities and promoting sound financial management is clearly an important part of these functions. These financial issues are at the core of good management and good government. Oversight by the Inspector General throughout the financial audit process, and other work that we do with respect to oversight, is a high priority in the OIG. We welcome the opportunity to report on about our work.

As you know, the Semiannual Report is our regular means of reporting to Congress. In our *Semiannual Report No. 37*, the then Acting Inspector General in his “Message to Congress” reported that the Department had had longstanding problems in its financial and accounting systems, with the result that a full-scope financial statement audit would not be completed until August 1999, five months after its Congressionally mandated due date. In *Semiannual Report No. 38*, the then Acting Inspector General’s “Message to Congress” again reported that the

Department's financial records were not ready for audit. He noted that the Department's delay in furnishing us with the trial balance and financial statements would delay our audit for an additional two months. Our most recent semiannual report, *Semiannual Report No. 39*, discusses the transmittal of the disclaimer of opinion on the Department's Fiscal Year 1998 financial statements.

Our communications with Congress on these financial management issues have not been limited to the Semiannual Report. In January and December 1998, we provided the Majority Leader of the House of Representatives, in response to his requests, with detailed descriptions of the Department's top ten management problems, which included issues relating to the Department's financial management systems.

Today is the opportunity to present my first testimony as the new Inspector General. As noted above, I have asked Mr. Steven McNamara of the OIG to accompany me so that we may respond fully to any questions the Subcommittee may ask. I requested and received information from E&Y to assist me with preparing my comprehensive testimony. I have incorporated their information into my testimony, particularly those sections relating to:

- Scope of the Contract with Ernst & Young,
- Guiding Standards for this Engagement, and
- Detailed Results of Ernst & Young's Procedures.

Scope Of The Contract With Ernst & Young

The Office of the Inspector General contracted with E&Y on June 24, 1998 to conduct an audit of the fiscal year 1998 financial statements for the purpose of satisfying the requirements of the Government Management Reform Act (GMRA).

In accordance with the contract, the scope of the work for fiscal year 1998 was to:

- Determine and report on whether the fiscal year 1998 Principal Statements are presented in all material respects in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements."
- Determine and report on whether the Department of Education's internal control structure provides reasonable assurance of achieving the internal control objectives described in OMB Bulletin No. 98-08.
- Determine and report on whether the Department of Education has complied with applicable Federal laws and regulations which could have a direct and material effect on the Principal Statements.
- Assess whether the information and manner of its presentation in the Overview of the Reporting Entity and in the Supplemental Financial and

Management Information sections are materially inconsistent with the information in the Principal Statements.

Guiding Standards For This Engagement

The engagement was to be performed in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States, Office of Management and Budget Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*¹, and generally accepted auditing standards issued by the American Institute of Certified Public Accountants. According to the Statement of Auditing Standards (SAS) No. 1, as amended by SAS No. 78 and SAS No. 82:

“The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position...in conformity with generally accepted accounting

¹ OMB Bulletin 98-08 sets forth the audit requirements for Federal Financial Statements. The Bulletin is designed to provide the necessary audit guidance in connection with the implementation of the CFO Act, as expanded by GMRA, and provides formal definitions for a number of technical terms and requirements used throughout the Bulletin and formalizes a number of significant CFO Act requirements including:

- Defines audit scope
- Provides agency IGs with primary responsibility for the execution of audits; allows the IG to provide for the execution of the audit by independent external auditors, and provides for audits to be performed by the Comptroller General of the United States (in consultation with the IG)
- Provides guidance on the IG’s role, such as to:
 - Ensure that audits are performed and audit reports completed in a timely manner and in accordance with the requirements of this Bulletin. This responsibility pertains to audits conducted directly by IG staff and audits conducted by independent auditors under contract.
 - Provide technical advice and liaison to agency officials and independent external auditors.
 - Obtain or make quality control reviews of audits made by independent external auditors and provide the results, when appropriate, to other interested organizations.

principles.... These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles..."

In short, the auditor has a responsibility to obtain reasonable but not absolute assurance about whether the financial statements are free of material misstatement.

SAS No. 1 also states that the financial statements are management's responsibility. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility.

Pursuant to GMRA, audited financial statements must be provided to OMB by March 1 of the fiscal year following the fiscal year under audit. To accomplish this objective, engagement planning typically begins in mid-May of the year to be audited. Interim procedures are performed during the months of June through

mid-August, with the auditors returning in mid-October after the Federal agency has closed its books. The year-end audit procedures are completed by February of the following fiscal year. Finally, the reporting phase of the audit is completed by March 1.

With respect to the Department of Education, the initial planned timeline was to conduct the audit in the same process as described above, with the exception of planning, which would be performed concurrently with interim testing. Early in the process, it became evident that the Department did not believe it could meet the timelines identified in the contract.

Fiscal Year 1998 Results Of The Engagement

I transmitted the final FY1998 reports prepared by E&Y to the Secretary on November 18, 1999. The reports were issued late because the Department's financial statements and records were not ready to be audited. The work performed resulted in a report containing a disclaimer of opinion on the financial statements due to weaknesses with the financial system. Weaknesses included the system's inability to perform a year-end closing process or produce automated consolidated financial statements. In addition, the Department did not adequately perform reconciliations and could not provide sufficient documentation supporting transactions.

A Report on Internal Controls was also issued documenting seven weaknesses. The three most serious of these were as follows: the accounting system's inability to perform a year-end closing process or produce automated consolidated financial statements; the lack of proper or timely reconciliations of the accounting records; and, deficiencies in controls surrounding information systems.

Finally, a Report on Compliance with Laws and Regulations was issued documenting two instances of noncompliance. These were: failure to meet the March 1, 1999 statutory deadline for submission of audited financial statements to OMB, as required by the GMRA; and, and non-compliance with the system requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

The OIG began the audit process with the Department and our new contract auditors, E&Y, in July 1998. However, by early August, the then Chief Financial Officer informed the OIG that the Department's books and records would not be ready for audit until February 1999. As a result, the audit was suspended and did not begin again until February 1999. In the interim, the OIG and E&Y met monthly with the Department to stay informed of the progress of financial statement preparation efforts.

As described in the Report on Internal Control, financial systems weaknesses and management turnover in the Office of Chief Financial Officer combined to make the preparation of financial statements a formidable task. From February until early June, work was performed where possible by E&Y, while working with the Department to obtain final versions of a trial balance, the financial statements, and notes thereto. In mid-June, the OIG, E&Y and the Department agreed the focus should be changed to supporting an opinion on the Balance Sheet and Statements of Net Cost and Changes in Net Position, with all supporting documentation to be received by July 16th. In early July it was decided to further narrow the focus to the Balance Sheet only. The consequences of this was, at best, the Department would not receive an opinion on at least four of the other statements. None of these approaches were successful and as a result, the OIG recommended suspending work on the FY 1998 financial statements. This was mutually agreed to, by the Department, E&Y and the OIG, that continuing the FY 1998 engagement would adversely affect the audit of the FY 1999 statements. The end of field work was September 15, 1999. Draft reports were provided to the OIG and the Department for review and comment. This process was completed on November 18, 1999 with the issuance and transmittal of the final reports. The Acting Chief Financial Officer indicated that with regard to the issues in the reports, the Department was in general agreement and was developing a comprehensive corrective action plan. A detailed chronology of key events relating to the FY 1998 audit process is

attached as Appendix 1. My transmittal letter to the Secretary and the final reports are attached as Appendix 2.

The reports on the 1998 financial statements will be the last ones to extend beyond the statutory deadline. I am committed to meeting the March 1, 2000 deadline for the audit of the 1999 financial statements and all those that follow.

Detailed Results Of Ernst & Young's Procedures

As a result of the engagement procedures followed, and as documented in their Report of Independent Auditors, E&Y was unable to determine whether or not the financial statements presented fairly, in all material respects, in conformity with Federal accounting standards, the: (1) assets, liabilities, and net position; (2) net costs; (3) changes in net position; (4) budgetary resources; and (5) reconciliation of net costs to budgetary obligations. Accordingly, a disclaimer of opinion was issued, which indicates that E&Y did not express an opinion on the financial statements.² A Report on Internal Control was also issued which detailed reportable conditions relating to significant deficiencies in the design or operation of internal control that could adversely affect the Department's ability to record, process, summarize and report financial data consistent with the assertions of

² According to the Statement of Auditing Standard No. 79, "the auditor can determine that he is able to express an unqualified opinion only if his audit has been conducted in accordance with generally accepted auditing standards and if he has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of his audit, whether imposed by the client or by circumstances, such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report."

management in the financial statements.³ A Report on Compliance with Laws and Regulations was issued which indicated that the Department had not complied with the FFMIA of 1996.

Report of Independent Auditors

A disclaimer of an opinion was issued because E&Y was unable to determine whether the fiscal year 1998 financial statements were presented in all material respects in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements." The disclaimer of opinion was issued due to the following matters. The Department operated under a new financial management software package in fiscal year 1998. The financial management software package had several limitations in the financial reporting process. Weaknesses included the inability to perform a year-end closing process or produce automated consolidated financial statements, which were significant factors in the Department's inability to prepare accurate consolidated financial statements in a timely manner. In addition to the weaknesses surrounding the financial management software package, the Department did not adequately perform

³E&Y noted certain matters involving internal control and its operation that they consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, as amended. Reportable conditions involve matters coming to the auditor's attention relating to significant deficiencies in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

reconciliations on account balances and could not provide sufficient documentation supporting transactions. As a result of these limitations, E&Y was unable to obtain sufficient evidential support for the amounts presented in the consolidated balance sheet as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

Report on Internal Control

In addition to the Report of Independent Auditors, a Report on Internal Control was issued, which documented the following reportable conditions, of which the first three were material weaknesses:

- Financial Reporting Needs to Be Strengthened (Repeat Condition⁴ - Material Weakness)
- Reconciliations Need to Be Improved (Repeat Condition - Material Weakness)
- Controls Surrounding Information Systems Need Enhancement (Repeat Condition - Material Weakness)
- Documentation Supporting Liabilities/Obligations was Insufficient
- Controls Surrounding the Monitoring of the Department's Programs Need to be Strengthened (Repeat Condition)
- Insufficient Controls Surrounding Accounts Receivable/Cash Receipts

⁴ Repeat condition means the issue was also included in the FY 1997 Report on Internal Control issued by the ED OIG.

- The Department Needs to Establish Controls Over the Analysis and Reporting of Performance Measures (Repeat Condition)

All the weaknesses identified above can be attributed primarily to the following:

1. The Department implemented a new financial management software package which made it more difficult for the Department to prepare its fiscal year 1998 financial statements.
2. There was significant turnover of personnel in the Office of the Chief Financial Officer (OCFO). As a result, there was limited guidance and leadership for individuals in the OCFO.
3. In fiscal year 1998, OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, imposed additional reporting requirements on Federal agencies, such as increasing the number of required statements from two to five. Without a stable management structure and implementation of the new financial management software package, the Department encountered significant difficulties related to the preparation of its fiscal year 1998 financial statements.

Report on Compliance with Laws and Regulations

The Report on Compliance with Laws and Regulations disclosed that the Department's financial management systems did not substantially comply with the requirements outlined in the FFMIA of 1996⁵. The Report on Internal Control includes information related to the financial management systems and accounting standards that were found not to comply with the requirements, and presents relevant facts pertaining to the noncompliance and our recommendations related to the specific issues. Specifically, it was noted that the Department lacked adequate financial management systems, reports and oversight to prepare timely and accurate financial statements.

Comparison Of FY 1998 With Previous Years

You asked how the findings reported for FY 1998 compared with previous Department-wide audits. The Department received a disclaimer for three of the four years. Overall, the findings identified in the Report on Internal Control for 1998 are substantially the same as those reported in prior years.

The Department was unable to receive an opinion on the FY1995 and FY1996 financial statements due primarily to a lack of reliable and complete data supporting the estimated liability for loan guarantees related to the Federal Family Education Loan Program (FFELP). This barrier to a clean opinion was

⁵ Under FFMIA, the auditor is required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To

overcome for the FY1997 financial statements through an extraordinary data gathering effort by the Department, guaranty agencies and their independent public accountants, the OIG and its contract auditors at that time. This was the culmination of 18 months of effort that began initially for the FY 96 financial statement audit. This provided reliable and complete data independent from the Department's systems that enabled an opinion to be expressed.

From 1995 through 1998, repeated internal control weaknesses were reported in the areas of:

- reconciliation of Fund Balance with Treasury,
- overall monitoring of Department programs, and
- information systems controls.

For fiscal year 1997, financial reporting was identified as a new significant control weakness. It was reported again in 1998. In contrast, in FY 1998 the Department was able to correct the longstanding significant control weakness related to its FFELP loan liability estimate.

Both the FY 1997 and FY 1998 Report on Compliance with Laws and Regulations contained the finding that the Department did not meet the statutory reporting date of March 1 and did not comply with the requirements of the FFMIA.

meet this reporting requirement, E&Y performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin 98-08.

Financial Management Practices

You also asked me to discuss developments in the Department's financial management practices in recent years. As I have discussed, findings on internal control over the past four years are substantially the same. The one exception would be the Department's resolution of issues related to its FFELP loan liability estimates.

Although still reported as a control weakness for FY1997, this barrier to an opinion was overcome for FY1997 primarily by: (1) working around the Department's system for the loan liability estimate, and (2) extending the audit effort. Subsequently, for FY 1998, the Department used data from its National Student Loan Database to prepare the FY1998 FFELP loan liability estimate and E&Y reported this issue as resolved.

The Department has made other efforts to improve its financial management such as preparing interim statements, using contractors to help prepare statements and instituting automated processes to prepare the consolidated trial balance and financial statements. However, I won't know the impact these efforts will have until E&Y completes its audit for FY 1999. I am committed to meeting the March 1 deadline.

Two additional, closely related control weaknesses emerged in FY 1997 and were repeated in FY 1998. They concerned financial reporting and controls surrounding information systems. Due to weaknesses in financial reporting, the Department was unable to prepare timely and supported financial statements from its general ledger system. The Department implemented a new general ledger system for fiscal year 1998 that was unable to perform a year-end closing process or produce automated consolidated financial statements. The Department is in the process of procuring a replacement system.

Systems control weaknesses related to EDCAPS included deficiencies in such areas as development and testing of a disaster recovery plan and access controls. In addition, weaknesses were noted in physical and environmental controls over computer rooms.

Recommendations For Improvement

The OIG and its contract auditors have made recommendations for improving financial management in a variety of areas. Over the years, the financial audit reports have resulted in multiple recommendations for improving financial management. For example, the FY1998 Report on Internal Control contained 28 recommendations that addressed improving financial management. These recommendations focused on such key areas as:

- strengthening financial reporting;

- improving reconciliations; and
- enhancing controls surrounding information systems.

A few specific recommendations included: ensuring that proper documentation is maintained to support transactions and adjustments; reconciling Fund Balance with Treasury accounts on a monthly basis; and defining procedures for granting and controlling access to the computing resources.

In addition to the financial audit, there has been a substantial amount of work performed by the OIG relating to the Department's Grant Administration and Payment System (GAPS). The OIG has performed extensive work and has issued a variety of products between March 1998 and May 1999 relating to GAPS. This work has resulted in numerous recommendations to improve security of the systems and integrity of the data.

Monitoring Implementation Of Recommendations

Audit standards require follow-up on known material audit findings from previous audits that could affect the financial statement audit in order to determine whether the auditee has taken timely and appropriate corrective actions. The status of uncorrected material findings and recommendations from prior audits of the financial statements must be reported. As indicated in the FY 1998 Report on Internal Control, a status of prior year's findings was presented.

In addition, the OIG has a tracking system which monitors implementation of corrective actions by management. Management prepares a corrective action plan in response to audit recommendations and reports semiannually on its progress to the OIG. The OIG keeps recommendations open in the tracking system until corrective actions are completed. These results are reported in the OIG's and the Department's Semiannual Reports to Congress. With regard to the Department-wide financial statement audits there were a total of 115 recommendations, of which 88 remain open and 27 are closed. Examples of key issues for which recommendations remain open include: financial reporting; reconciliations of Fund Balance with Treasury; and information systems controls.

Closing Comments

I am committed to issuing the audit report on the Department's FY 1999 financial statements in time to meet the March 1 deadline. I am also committed to providing timely, quality audit services to the Department to enable it to improve financial management, and keeping the Department and Congress informed of the results of our work. At this time, Mr. McNamara and I would be pleased to answer any questions you may have.

Chronology of Key Events Relating to the FY1998 Audit Process

- June 24, 1998 Ernst & Young (E&Y) was awarded the contract to perform the audit of the Department of Education's fiscal year 1998 financial statements. Pursuant to this contract, the fiscal year 1998 audit was to be completed by March 1, 1999.
- July 14, 1998 Introductory meeting of E&Y with representatives from the Office of Inspector General (OIG). At this time, Mr. John Higgins was the Acting Inspector General. Note the IG position was filled by Ms. Lorraine Lewis in June 1999.
- July 22, 1998 Initial meeting with the OIG, E&Y, the Office of the Chief Financial Officer (OCFO), and the Office of Postsecondary Education (OPE).
- September 1, 1998 Received OCFO's proposed schedule for modification to the audit timeline.
- September 3, 1998 Met with the OIG to discuss the impact of the OCFO's proposal to delay the audit. E&Y indicated that the impact could be less severe if E&Y were permitted to remain onsite to perform planning and testing of internal controls during the period of September 1998 to February 1999.
- September 10, 1998 Met with the OIG and Department officials. OCFO management determined that it would be less disruptive to the financial statement preparation process if E&Y completely pulled out of the Department of Education and returned in February 1999 to begin the audit. At this meeting, the CFO indicated that the trial balance, financial statements, and reconciliations would be provided to E&Y by February 8, 1999. All parties agreed to the delay with the acknowledgment that the March 1 statutory deadline would not be met. In addition, it was agreed that monthly status meetings would be held to enable the Department to inform the OIG and E&Y of its progress in preparing its financial statements, as well as completing the reconciliation of the Fund Balance with Treasury.
- February 11, 1999 E&Y held the opening conference with officials from the Department of Education. GAO was in attendance as well. Neither the trial balance nor the financial statements were available. OCFO did not anticipate having the trial balance available to E&Y until early March.
- March 15, 1999 The OIG requested a meeting with E&Y to discuss the problems encountered to date with the audit and to evaluate the OIG's options with respect to the continuation of the audit.

Chronology of Key Events Relating to the FY1998 Audit Process

March 24, 1999	The OCFO provided the first draft of the trial balance, Balance Sheet, Statement of Net Costs, and the Statement of Changes in Net Position. These draft financial statements did not agree with the trial balance. We were unable to utilize these statements for audit purposes.
Early April 1999	OIG informed E&Y that the Chief Financial Officer had resigned from the Department.
May 18, 1999	Received another draft of financial statements three months after original commitment. There were still issues with these financial statements that needed to be resolved with the OCFO.
May 26, 1999	Received final trial balance approximately four months after original commitment to begin substantive testing.
Mid-June 1999	The OIG, E&Y and the Department agreed the focus should be changed to supporting an opinion on the Balance Sheet and Statements of Net Cost and Changes in Net Position, with all supporting documentation to be received by July 16 th . The consequences, at best, were that the Department would receive a disclaimer on at least two statements.
July 6, 1999	Received final financial statements from the Department five months past original February commitment.
July 12, 1999	The auditors changed the focus to the Balance Sheet only. The consequences, at best, were that the Department would receive a disclaimer on at least four statements.
July 20, 1999	The Deputy CFO provided E&Y a letter that indicated that the Department had determined to stop the fiscal year 1998 financial statement audit, and accept a disclaimer of opinion.
August 4, 1999	OIG, E&Y and the Department briefed GAO. In addition, the Department briefed OMB later in the day, which the OIG and E&Y also attended. The purpose of the briefings was to discuss the disclaimer of opinion and the reasons behind it, as well as the anticipated findings to be included in the Report on Internal Control.
September 15, 1999	Completed audit fieldwork.
November 9, 1999	Final draft of the Report of Independent Auditor, Report on Internal Control, and Report on Compliance with Laws and Regulations were provided to the Department.
November 12, 1999	Received final comments from the Department on all 3 reports. [Reports wait to be finalized until management representation letter is received.]

Chronology of Key Events Relating to the FY1998 Audit Process

- November 16, 1999 E&Y received management representation letter from the Department of Education.
- November 18, 1999 Provided the final reports to the OIG for distribution.



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 18 1999

Honorable Richard W. Riley
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

The enclosed reports present the results of the audit of the Department's annual financial statements for the fiscal year ended September 30, 1998, to comply with the Government Management Reform Act of 1994 (GMRA).

The Office of Inspector General (OIG) contracted with Ernst & Young, LLP, Certified Public Accountants, to perform the audit. The OIG monitored the progress and completion of the work to ensure compliance with *Government Auditing Standards*.

The results of the audit were discussed with Department officials throughout the audit. The Office of the Chief Financial Officer and Student Financial Assistance responded to the findings and recommendations presented in the draft audit reports and we incorporated changes as appropriate.

During the course of the audit, Ernst & Young, LLP, identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the OIG 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 and Ernst & Young, LLP, during the audit.

Sincerely,

Lorraine Lewis

Enclosures

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources and financing for the year then ended. These financial statements are the responsibility of the Department of Education's management.

As required by Office of Management and Budget (OMB) Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, Note 1 to the Principal Statements describes the accounting policies used by the Department to prepare these financial statements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

The Department operated under a new accounting system in fiscal year 1998. The accounting system has several limitations in the financial reporting process. The weaknesses with the system, such as the system's inability to perform a year-end closing process or produce automated consolidated financial statements, were significant factors in the Department's inability to prepare accurate consolidated financial statements in a timely manner. In addition to the weaknesses surrounding the accounting system, the Department did not adequately perform reconciliations and could not provide sufficient documentation supporting transactions. As a result of these limitations, we were unable to obtain sufficient evidential support for the amounts presented in the consolidated balance sheet as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the consolidated balance sheet as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

The information presented in the Overview and the Supplemental Statements is not a required part of the principal financial statements, but is supplementary information required by OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*. Such information has not been subjected to audit procedures, and accordingly, we express no opinion on it.

Report of Independent Auditors

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In accordance with *Government Auditing Standards*, we have issued our reports dated September 15, 1999, on our consideration of the Department of Education's internal controls and on its compliance with applicable laws and regulations.

Ernst + Young LLP

September 15, 1999
Washington, D.C.

Report on Internal Control

To the Inspector General
U.S. Department of Education

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources and financing for the year then ended, and have issued our report thereon dated September 15, 1999. The report states that because of matters discussed therein, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the consolidated balance sheet as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

Management is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that: assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with the hierarchy of accounting principles and standards approved by the principals of the Federal Accounting Standards Advisory Board; and data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent limitations in any internal control, errors and irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing the engagement, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal controls, determining whether these internal controls had been in operation, assessing control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

In addition, with respect to internal controls related to performance measures reported in the overview of the Department's consolidated financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by the Office of Management and Budget (OMB)

Report on Internal Control

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Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*. Our procedures were not designed to provide assurance on internal control over reported performance measures, and accordingly, we do not provide an opinion on such controls.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, as amended. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all matters in internal control which might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We have summarized the reportable conditions below, the first three of which are considered material weaknesses as defined above.

- Financial Reporting Needs to Be Strengthened (Repeat Condition)
- Reconciliations Need to Be Improved (Repeat Condition)
- Controls Surrounding Information Systems Need Enhancement (Repeat Condition)
- Documentation Supporting Liabilities/Obligations was Insufficient (Repeat Condition)
- Controls Surrounding the Monitoring of the Department's Programs Need to be Strengthened (Repeat Condition)
- Insufficient Controls Surrounding Accounts Receivable/Cash Receipts
- The Department Needs to Establish Controls Over the Analysis and Reporting of Performance Measures (Repeat Condition)

The weaknesses identified, discussed in detail below, can be attributed to several factors. First, the Department implemented a new accounting system, Education's Central Automated Processing System (EDCAPS), which does not easily facilitate the Department in its preparation of financial statements. Second, there has been a significant amount of turnover in the Office of the Chief Financial Officer (OCFO) causing limited guidance and leadership. Third, the Department did not have sufficient resources available for the preparation of the financial statements. Finally, the Department was required to report for fiscal year 1998 under OMB Bulletin No. 97-01, *Form and Content of Agency Financial*

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Statements. OMB Bulletin No. 97-01 placed additional reporting requirements on Federal agencies and without a stable management structure, as well as adequate systems, the Department encountered significant difficulties related to the preparation of its fiscal year 1998 financial statements.

In addition to resolving the findings noted, the Department will have added challenges as it prepares the fiscal year 1999 financial statements. The challenges result from the implementation of requirements within the Government Performance and Results Act of 1993, and the recent authorization under the Higher Education Act Amendments of 1998, which afforded the Department the opportunity to establish a Performance-Based Organization (PBO), the Office of Student Financial Assistance (OSFA). Both these pieces of legislation add additional reporting requirements for fiscal year 1999. For example, the OCFO will be responsible for preparing the fiscal year 1999 financial statements for both the Department and OSFA. To overcome the challenges, the Department must ensure that proper resources are allocated to the preparation of the Department's and the OSFA's fiscal year 1999 financial statements.

MATERIAL WEAKNESSES

1. Financial Reporting Needs to Be Strengthened (Repeat Condition)

The Chief Financial Officers (CFO) Act and, in particular, OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, require that financial statements be the culmination of a systematic accounting process. The statements are to result from an accounting system that is an integral part of a total financial management system containing sufficient structure, effective internal controls, and reliable data. Our fiscal year 1998 procedures found that the Department lacked adequate financial management systems, reports and oversight to prepare timely and accurate financial statements.

The following provides a few examples of the issues encountered during our review of the Department's financial statements and the related process surrounding the preparation of its financial statements:

A. General Ledger

We noted significant weaknesses in the Department's financial reporting processes, as discussed throughout this report. One of the significant weaknesses in the reporting process relates to the EDCAPS general ledger software package, Financial Management System Software (FMSS). Refer to the finding, *Controls Surrounding Information Systems Need Enhancement*, for additional issues specific to the system. The weaknesses in the general ledger system were driving factors in the Department's inability to prepare accurate financial statements in a timely manner. Currently, FMSS does not allow the user to perform a year-end closing process. For example, the FMSS general ledger trial balances contain two fiscal years of revenue and expense data (fiscal years 1997 and

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1998), and the assets and equity accounts do not reflect the proper balances. In addition, FMSS did not allow the Department to produce a general ledger trial balance at the reporting group level or at a consolidated level for fiscal year 1998. Instead, FMSS can only generate trial balances at the appropriation level.

As a result of the system deficiencies, the Department devoted a significant amount of resources, both personnel and time, to preparing an ad-hoc consolidated trial balance. The ad-hoc trial balance (referred to as the “as if” trial balance) simulates a year-end close for fiscal year 1997 in order to provide the Department with the ability to generate a trial balance with only fiscal year 1998 revenue and expense data.

The Department is working with a contractor to implement a year-end close process. According to management, an automated reporting process has been developed and will be incorporated prior to the close of fiscal year 1999. This reporting process should enable the Department to produce a pre-close and post-close trial balance at the appropriation level. However, FMSS will still not be able to produce a trial balance at the consolidated level.

B. Financial Statement Preparation

As a result of the general ledger deficiencies discussed above, it was necessary for the Department to write a program to extract the general ledger accounts from its accounting system, in order to prepare the fiscal year 1998 financial statements. The process represents a “query” of the general ledger database, which is a process of searching for data, as programmed by Department personnel, to retrieve and summarize the data in a certain format. These queries were performed at the appropriation level; as a result, the Department started the reporting process with over 200 sets of financial statements. The appropriation level financial statements were then analyzed by OCFO staff, and adjustments were posted, as deemed necessary. The 200 sets of adjusted financial statements were then “rolled-up” to produce financial statements at the reporting group level, and then finally at the consolidated level. As a result of this process, the Department posted over 700 adjustments and/or reclassifications to its trial balances in order to generate a final working trial balance to prepare its fiscal year 1998 consolidated financial statements.

Several significant weaknesses in the financial statement preparation process were noted. The following represent a few examples of the weaknesses noted:

- The financial statements were not reconciled to the trial balances to ensure that all amounts were properly included. As a result, significant variances between the trial balances and the financial statements existed. A proper reconciliation would have facilitated the Department in preparing one set of financial statements rather than the several sets that were provided.

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- The financial statements were prepared at the appropriation level, which was very time consuming and resource intensive. Due to the large volume of data and paperwork involved in the preparation of the financial statements at the appropriation level, many errors and adjustments in the statements went undetected by the Department. For example, the parameters used to simulate closing and the creating of the “as if” trial balance were not complete or inclusive. When the trial balance was compared to the OMB Bulletin No. 97-01 crosswalk, there were accounts that were excluded from the Department’s parameters as well as accounts which were added from the Department’s chart of accounts. In addition, accounts which were added and excluded were not adequately documented.
- Many adjustments posted to the financial statements were not adequately tracked and documented. As a result, not all adjustments were properly posted to the general ledger. For example, a \$550 million adjustment was posted incorrectly, thereby creating a net difference of approximately \$1.1 billion to expenditures. Through discussions with OCFO personnel, we were informed that the data obtained from FMSS was incorrect and, accordingly, adjustments to the trial balances were needed to make the financial statements reflect balances which the Department believed the accounts should contain. The Department was able to provide the journal vouchers (JVs) indicating the accounts affected by the adjustments; however, the JVs did not always contain the reason that the adjustment was needed. As a result, we were unable to determine the validity of several of the adjustments. For example, we identified one adjustment of approximately \$400 million that was invalid and needed to be reversed.
- Given the system’s limitations and the manual process surrounding the preparation of financial statements, the Department does not have sufficient resources to prepare financial statements timely. In addition, the Department did not prepare sufficient guidance memorandums, as outlined in OMB Bulletin No. 97-01, for the financial and program management personnel responsible for the preparation of the annual financial statements. As a result, the Department was unable to meet the statutory reporting deadline of March 1, 1999, for its fiscal year 1998 audited financial statements.

C. Net Position

The Department was unable to adequately support the net position balance as of September 30, 1998. Specifically, the Department was unable to sufficiently support the breakout between unexpended appropriations and cumulative results of operations. The majority of the issues surrounding net position resulted from the Department’s conversion from the Primary Accounting System (PAS - the general accounting system used in fiscal year 1997) to FMSS (the general accounting system implemented and used during fiscal year 1998). As a result of the conversion, this was the first year that the 5700 account (Appropriated Capital Used) had been utilized by the Department. However, according to

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OCFO personnel, certain transactions were recorded in the 5700 account that should not have been. In addition, there were other transactions that should have been recorded in the 5700 account, but were not reflected in the account. Therefore, the Department had to make several adjustments to this account throughout the entire year.

To support net position, we were provided an equity analysis performed by the OCFO. However, upon review of the equity analysis and the related supporting documentation, we noted that many of the adjusting entries were not properly reflected in the net position balance. In addition, we noted that many of the adjusting entries did not have adequate support documenting the reason for the adjustment. The supporting documentation, if provided, was mainly the coding sheets (e.g., journal vouchers) which indicated which general ledger account should be adjusted.

Recommendations:

We recommend that the Department of Education perform the following:

1. Define and document the information system requirements to efficiently manage operations and then develop or modify reports to meet reporting and reconciliation requirements.
2. Prepare a strategic plan for financial reporting which identifies: (1) milestones for specific procedures that need to be performed in order to prepare interim and annual financial statements; (2) individuals responsible for each of the procedures identified as part of the financial reporting process; and (3) deadlines for each critical phase of the financial statement preparation.
3. Review and enhance its current policies and procedures to ensure that sufficient guidance is available for the Department's personnel on the year-end closing process, and the preparation of the financial statements. Such guidance should be distributed to all Department personnel involved with the financial statement process. The Department should also ensure that the policies and procedures are updated to incorporate the financial reporting needs of the OSFA.
4. Clearly define roles and responsibilities for the Department's personnel involved in the preparation of the Department's consolidated financial statements, and OSFA's financial statements. In addition, we recommend that the Department provide additional training to its personnel related to the policies and procedures surrounding the preparation of the Department's and OSFA's financial statements. Such training should incorporate the additional reporting needs of OSFA's financial data. For example, the Department should provide guidance on how Departmental overhead costs are intended to be allocated to OSFA.

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5. Ensure that appropriate and adequate quality assurance procedures are performed during the financial statement preparation process.
6. Ensure that adequate resources are allocated to the preparation of the financial statements.
7. Ensure that proper supporting documentation is maintained to substantiate transactions and adjustments.

2. Reconciliations Need to be Improved (Repeat Condition)

A major objective of internal controls is to ensure the integrity of the underlying accounting data supporting the financial statements. An important control in this regard is the periodic reconciliation of the Department's accounting records. An adequate reconciliation provides the assurance that processed transactions are properly and timely recorded in the Department's accounting records and financial statements, which then facilitates management's ability to analyze its financial condition and results of operations on a routine basis.

In general, we noted that the Department did not perform proper or timely reconciliations of its financial accounting records. On numerous occasions, we noted that the Department adjusted its general ledger to reflect the balance per the subsidiary records, without sufficiently researching the cause for the differences. The following provides a few examples in which reconciliations were not performed on an adequate, regular or timely basis:

A. Fund Balance with Treasury

As indicated in the prior year's Report on Internal Controls, the Department has had difficulty identifying and resolving differences between its accounting records and cash transactions reported by Treasury for several years. There are many underlying reasons for the Department's difficulties. One reason is that formal reconciliation procedures were not performed on a current or regular basis. Another reason is that reconciliations were inconsistently performed and identified differences were not always adequately explained, resolved and posted to the Department's general ledger. The following represent examples of issues identified during our testing of the Department's reconciliation of Fund Balance with Treasury:

- While testing the Statement of Difference (TFS 6652), we inquired about the Statement of Transactions (SF 224) preparation process to verify how differences in the TFS 6652 were corrected in subsequent periods. We found that the transactions the Department reported to Treasury on the SF 224 differed from the transactions posted to the general ledger in every period throughout fiscal year 1998, creating large reconciling differences, which were adjusted to equal the balance shown by Treasury

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in the cash reconciliation process. Also, we noted that some of the reconciling differences were not corrected until eight months after being reported in the TFS 6652.

- Differences noted between Treasury and the Department's records were not adequately researched. In order to bring its accounts into agreement with Treasury, the Department would record the identified differences to its suspense, grantback, or budget clearing accounts without fully researching and resolving the difference. For example, when testing the Budget Clearing Account (F3875), we noted that differences were not corrected or communicated to Treasury on a timely basis which made the reconciliation at year-end difficult due to the large volume of unreconciled differences.
- As of September 30, 1998, the FMSS balance of the Grantback Account (X6191) was \$398,928,914. Of this balance, \$386,333,328 was composed of several adjustments that have accumulated since fiscal year 1993 for reconciling differences of various appropriations that could not be identified with any specific program. We received an Analysis of Canceled Funds Held in the Grantback Account. Based on this analysis, the Department developed two approaches to use in calculating the amount of the Grantback account that needed to be returned to Treasury. The first approach, based on a percentage of active appropriations, indicated that the Department should return \$221,852,046 to Treasury. The second approach, based on total active funds in the Grantback account, indicated that the Department should return \$15,421,299. Although the fiscal year 1998 analysis was performed, the Department did not return additional funds to Treasury for the following reasons: (1) funds from the Grantback account might be used to compensate for reconciling differences between the Grant Administration Payment System (GAPS) and FMSS, and (2) funds from the Grantback account might be needed to balance differences among grant appropriations between Treasury and the general ledger.

Based on our testing and discussions with OCFO personnel, the Department cannot readily determine to which appropriations the excess funds in the Grantback account belong due to the following reasons: (1) assurance that funds from canceled appropriations were not transferred to active appropriations could not be provided; and (2) supporting documentation for the budgetary balances could not be provided.

These are some of the reasons that large differences accumulated during the year between Treasury and the Department's general ledger Fund Balance with Treasury account, making the reconciliation process more difficult. In addition, the majority of these differences were posted to Fund Balance with Treasury to increase or decrease the balances of budget clearing and suspense accounts.

The Department's delay in performing its reconciliation of the Fund Balance with Treasury account exposes the Department to greater risk that material errors or irregularities could

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occur and not be detected on a timely basis. The reliability of accounting data and management control over cash transactions as reported to Treasury diminishes when reconciliations are not performed in a consistent or timely manner.

The Department attributes its reconciliation difficulties to inadequate integration between its general ledger system and its payments and funds control systems, which are the original points of entry for many cash transactions. These integration issues result in certain cash transactions not being properly and timely transferred from the originating systems to the Department's general ledger system, thus causing the Department's Fund Balance with Treasury as recorded per the general ledger to differ from Treasury.

B. Grant Expenditures

The Grant Administration and Payment System (GAPS) is used by grantees to drawdown funds, via the internet, from the Department. The transactions are electronically accumulated and transmitted to FMSS, the Department's general ledger. Accordingly, the expenditure and drawdown data reported in GAPS should be equal to the expenditure and drawdown data in FMSS. However, during our testing of grants, we noted that the Department did not reconcile its grants subsidiary ledger, GAPS, with the FMSS general ledger during fiscal year 1998. As a result and due to impending time constraints, the Department was unable to explain a difference of approximately \$134 million between FMSS and GAPS.

In addition, the Department did not have formal policies and procedures in place to perform reconciliations between GAPS and FMSS. The Department did not perform grant expenditure reconciliations until after the end of the fiscal year. Given the high volume of transactions that flow through GAPS (over \$20 billion per year) the Department's delay in performing the reconciliation of grant expenditures increases the risk that material errors or irregularities could occur and not be detected on a timely basis.

Although the adjustment capabilities available to grantees are beneficial in curbing excess cash held by grantees, adjustments are posted to FMSS when made and cannot be applied to any other period than the present. Therefore, if a grantee makes an adjustment after year-end for prior year transactions, there is an increased risk that the adjustment would not be posted in the proper period.

C. Other Areas

The Department did not perform year-end reconciliations to properly identify the differences (if any) between the general ledger balance and the detail in the Debt Collection Management System (DCMS). Instead, the receivable balance in the general ledger was adjusted to the subsidiary report balance generated from DCMS without a reconciliation of the difference. In addition, there are no reconciliations between the loans the GAs assigned to the Department and what gets accepted in the system. We noted

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discrepancies between the GA confirmations and DCS records for loans assigned during the year.

Weaknesses in the Department's internal controls over the reconciliation process prevented timely detection and correction of errors in its underlying accounting records. Further, the delays experienced in completing its reconciliations was a contributing factor in preventing the Department from submitting audited fiscal year 1998 financial statements by the statutory deadline of March 1, 1999. In addition, the fiscal year 1998 implementation of EDCAPS also contributed to the Department's inability to perform routine reconciliations. The general ledger portion (FMSS) of EDCAPS was not adequately integrated with other financial reporting systems during the fiscal year, thereby reducing the Department's ability to systematically perform reconciliations.

Recommendations:

We recommend that the Department of Education perform the following:

1. Review and update its current policies and procedures surrounding reconciliations of all significant accounts. These policies and procedures should be specific in order to provide sufficient guidance to the Department's personnel. The Department should review its policies and procedures on a regular basis to ensure that they remain current and are achieving the Department's intended management objectives.
2. Reconcile the Fund Balance with Treasury accounts on a monthly basis. The reconciliations should include documentation of the research performed and the resolution of the issue. All differences identified should be researched and resolved in a more timely manner. Management should consider implementing specific policies and procedures addressing items that have been recorded in the suspense, grantback and budget clearing accounts. The policies should ensure to document the intended purpose of these accounts and address the type of activity that should flow through them. The procedures should document the review and approval process for reconciling transactions. The review process should also include providing management with summary reports indicating the reasons why the items have not been cleared from these accounts and that transactions in these accounts are appropriately classified. For example, the grantback account should be cleared to include only those transactions that are specific to grantback activity. Limited amounts should be reflected in these accounts as of the fiscal year end.
3. Perform regular reconciliations of all significant accounts. All correcting entries should be posted in a timely manner. In addition, documentation should be maintained to support the correction. Such documentation should include, at a minimum, an indication of who prepared the reconciliation, as well as the date of preparation, evidence of supervisory review, the accounting entries associated with any adjustments, and the reason for the adjustments.

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

In connection with the annual audit of the Department's fiscal year 1998 financial statements we conducted a general controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular No. A-130 requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resources management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system noting that manual procedures are generally not a viable back-up option.

As a result of procedures performed, the following deficiencies were noted:

- The development, documentation, and testing of a comprehensive disaster recovery plan for all of the systems and business processes has not been finalized. Without a documented and tested disaster recovery plan, the timely restoration of EDCAPS in the event of a disaster may not be possible, thereby preventing the Department from resuming business in an adequate manner.
- User account and password standards stated in the EDCAPS Security Plan are not fully implemented. Each individual system and application within EDCAPS has various user ID and password settings that differs from the policies outlined in the Security Plan.
- The approach and methodology for design, selection, coordination and maintenance of information technology architecture has not been formally documented.
- The Security Plan does not contain current procedures for requesting, authorizing, revalidating, and granting access to computing resources. In addition, the Department does not comprehensively log, monitor, review access, or issue alerts to sensitive computing resources. There is no process for security violation monitoring, investigation, and resolution.
- Physical and environmental controls over computer rooms are not sufficient. For example, critical computing equipment is not adequately protected from water damage, and there are large amounts of combustible materials in the computer rooms. We also noted that documentation of authorizations for card key access was incomplete. Furthermore, the revalidation procedures for card key access to the computing resources are not effective. Lastly, there are no documented policies and

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procedures with respect to physical and environmental controls over all computing resources.

Recommendations:

The Department of Education should perform the following:

1. Continue to develop a disaster recovery plan. Once developed, the plan should be tested and updated regularly to assess its effectiveness.
2. Enhance user account and password controls over EDNET and EDCAPS applications and enforce security policies that are stated in the Security Plan.
3. Develop and implement a formal approach and methodology for designing and maintaining its IT architecture. The plan should also clearly define related roles and responsibilities.
4. Update the security policies and procedures to reflect the changing system security needs. In addition, the Department should implement periodic reviews of the plan to ensure that changes to systems and processes are adequately addressed. Procedures should be developed and implemented to ensure that all access authorizations are documented and that access rights are revalidated on a periodic basis.
5. Define, document, and implement comprehensive policies and procedures for granting and controlling access to the computing resources. Controls should be defined to ensure that all authorizations are properly documented and periodically reviewed for appropriateness. Policies and procedures should be developed to protect IT resources from physical and environmental threats.

REPORTABLE CONDITIONS

4. Documentation Supporting Liabilities/Obligations was Insufficient

The Department experienced significant delays and required significant staff resources to prepare data supporting its financial statements, as indicated above. In addition to those difficulties, the Department was unable to readily provide listings of outstanding accounts payable and accrued liabilities at September 30, 1998. According to *OMB Circular No. A-123*, documentation for transactions, management controls, and other significant events must be clear and readily available for examination. The following provides examples of the issues encountered during our testing of the fiscal year 1998 financial statements:

A. *Estimated Grant Liability*

The Department provides significant funding to grant recipients each fiscal year (over \$20 billion). During fiscal year 1997 and prior fiscal years, the Department collected data on actual expenditures incurred from grant recipients through the use of a Standard Form (SF) 272. Using the data on the SF 272, the Department was able to estimate its liability at the end of the fiscal year for expenses incurred by the recipients but not yet reimbursed by the Department, thereby creating an accrued liability.

Early in fiscal year 1998, the Department discontinued the use of the SF 272, thereby eliminating the need for the grantees to submit selected information. In addition, in May 1998, the Department converted its grant system from the Payment Management System (PMS) to the Grant Administration and Payment System (GAPS). Under the GAPS system, all cash drawdowns made by recipients are recorded as expenses in the period the cash is disbursed – in essence, grant expenditures are recorded on the cash basis rather than the accrual basis. The recording of grant expenditures on the cash basis, coupled with the fact that the Department no longer requires recipients to report actual expenditures periodically, impeded the Department's ability to adequately estimate the grant liability as of September 30, 1998.

Failure to reasonably estimate the grant liability accrual may result in a material misstatement on the Department's financial statements. However, we are unable to gain any assurance pertaining to the amount of misstatement.

The Department is currently exploring options for calculating the grant liability for fiscal year 1999, including requesting that the recipients submit, via confirmation by the Department, the information for the September 30 year-end.

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B. Accounts Payable

The Department does not generate a subsidiary ledger for its accounts payable. Therefore, in order to test the accounts payable balance, it was necessary to query the system (via COGNOS – a query software package) to obtain a listing of accounts payable as of September 30, 1998. As a result of the query, we noted that one of the reporting groups contained a positive accounts payable balance. The Department was unable to provide support pertaining to the debit balance. We also selected a sample from the query and requested supporting documentation. Management was unable to provide us with the supporting documentation for the sample items selected.

In addition to the lack of supporting documentation, we noted that the classification of accounts payable on the Department's financial statements did not agree with the system's classification. For example, the financial statements reflected certain amounts as either Intragovernmental (Gv) or Governmental (Co) but the transactions were coded the opposite way per the COGNOS query. We were informed that the sector flag (field for determining which sector) is not reliable within the system. We were also informed that it was likely that the field was populated incorrectly. A similar problem exists with the "covered by budgetary resources" and "not covered by budgetary resources" flags.

As a result of the above occurrences, we were unable to gain assurance as to whether or not the accounts payable balances were fairly stated or properly classified.

C. Obligations

As part of our review of the financial statements, we requested a report listing the Department's undelivered orders as of September 30, 1998. Although the Department was able to generate the report, the balance per the report did not agree with the notes to the financial statements. The difference between the undelivered orders report and the financial statements was approximately \$6 billion. The Department was unable to explain this difference.

In addition, the Department did not sufficiently de-obligate funds in a timely manner. During our review of the grant programs, we found that the award documents that required manual closings were not closed during fiscal year 1998. Only automatic closings were properly de-obligated. According to OCFO management, payees were not able to access funds after the liquidation period. However, obligations are overstated as a result of not performing the closings for manual de-obligations. We were unable to determine the amount of the overstatement since the Department's data processing system cannot retrieve information by historical date.

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D. Borrowings

During our testing of Borrowings from Treasury, we noted that many of the principal repayments to Treasury were made after September 30, 1998. For financial reporting purposes, the Department reflected the repayment of borrowings as if it had occurred by September 30, 1998. As a result of the principal repayments to Treasury, both Fund Balance with Treasury and Borrowings from Treasury are understated by approximately \$1.3 billion as of September 30, 1998.

Recommendations:

We recommend that the Department of Education perform the following:

1. Develop a methodology for estimating the year-end grant liability accrual and ensure that this methodology is completed promptly in order to facilitate the fiscal year 1999 financial statement audit.
2. Review its system requirements so that the Department can produce subsidiary ledgers in a timely manner, as well as substantiate all accounts payable transactions and obligations. The subsidiary ledger should also identify payables as either governmental, intra-governmental, covered by budgetary resources or not covered by budgetary resources.
3. Enhance current policies and procedures to ensure that all obligations are reviewed on a frequent basis, as well as at year-end, to ensure that all obligations are valid. Training should be provided to individuals responsible for performing the verification/validation of the obligations, and it should include de-obligation procedures.
4. Determine the funding needed for repayment of its borrowings and ensure that the payment occurs on or before September 30th. Policies and procedures should be developed to ensure proper reporting of transactions associated with borrowings.

5. Controls Surrounding the Monitoring of the Department's Programs Need to be Strengthened (Repeat Condition)

In order to achieve the objectives of the Higher Education Act of 1965, as amended, the Department utilizes the services of multiple outside entities (e.g., schools, guaranty agencies and lenders). Given the significant level of funding associated with these programs which flows through the outside entities, the Department must have adequate oversight of its programs. These programs include: the Federal Family Education Loan Program (FFELP), William D. Ford Direct Loan Program (Direct Loans), and the Grant Programs.

The Department established the following significant divisions to perform the necessary

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oversight of the outside entities: (1) Guaranty and Lender Oversight Service (GLOS), (2) Institutional Participation and Oversight Service (IPOS), and (3) Non-Title IV Grant Programs. During our audit testing of the Department's programs and its related oversight, we noted several areas for which controls over monitoring could be enhanced. The following provides some examples of issues we noted during our testing:

- As indicated in the previous year, some of the lender reporting packages did not strictly adhere to the established lender audit guide (Part IV). The lender reporting package must consist of specified reports and documents prepared by either the lender or an Independent Public Accountant (IPA). In several of the reports reviewed during our fiscal year 1998 testing, we found that some documents were not submitted to the Department as required by the guidance. In addition, of the twenty-five lender IPA Audit Reports sampled, we noted that seven reports were not submitted to GLOS within six months of the lender's fiscal year-end as required. We were also unable to determine if management's assertions were included as part of the management representation letter for one of the twenty-five reports sampled.
- We selected fifteen of the twenty-five Guaranty Agency (GA) IPA reports submitted to the Department during fiscal year 1998 to review. Of the fifteen sampled GA IPA reports: (1) four GAs did not submit their IPA reports to the Single Audit Clearinghouse within thirteen months of the fiscal year-end; (2) five reports were not received by the Department in a timely manner from the Clearinghouse (three weeks); (3) one report was processed without financial statements and respective auditor's opinion; (4) four reports were not received at GLOS (from IPOS) in a timely manner (within three weeks of receipt at IPOS); and (5) five reports were not/will not be closed by GLOS within six months from the date the report was received by GLOS.
- For our testing of the Single Audits, we selected a sample of 26 audits to review. Of the 26 Single Audit reports: (1) nine were not submitted to the Census Clearinghouse within thirteen months of the fiscal year-end; (2) nine were not received by the Department in a timely manner from the Clearinghouse (two months); and (3) one report was not issued by ED within six months of receipt. In addition, of the seven reports that had findings which required resolution, four were not closed within the six month time frame.
- We selected a sample of 12 program reviews to test at the New York regional office (Region 2). Of the 12 reviews selected, eight were close-out desk reviews (the institutions had closed). Of the eight, the Department was unable to collect funds due on five. At this time there are no requirements for an institution to set aside funds for a close-out audit or for close-out penalties. For one of the twelve reviews, the Program Review Report was not issued within 60 days of the review date. The Department was also late in issuing the Final Program Review Determination Letter on three reviews. Management indicated that the issuance of the Letter is contingent on the institutions providing the Department with specific information. Therefore, if the

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institutions do not provide the information timely, then the Department will be delayed in its issuance of the Letter.

- The Department does not maintain a subsidiary ledger system specific to tracking the receivables and reserves held by the individual GAs. During our testing of the reserve balances, we noted several inconsistencies between the amounts reported by the GAs on the Form 1130 versus what was submitted via confirmation request. Neither the GAs nor the Department were able to provide explanations for several of the differences noted. In addition, we noted that fourteen out of the thirty-six GA had reporting errors on their Form 1130, totaling approximately \$36 million.

The Department only performs a year-end analysis of the defaulted guaranteed loan receivable data maintained at the GAs. We recommend that the Department perform more frequent analysis so that any problems can be resolved in a timely manner. In addition, the Department does not compare outstanding principal balance data maintained in the National Student Loan Data System (NSLDS) to the Form 1130 on a routine basis. The NSLDS is primarily used to track information specific to loans such as principal and interest. Although there is no subsidiary ledger system that tracks individual GA activity, the Department should be able to extract data from NSLDS by GA or lender, to perform an analysis of the loan receivable data. Routine analysis of the GA data per NSLDS would facilitate the Department in monitoring its loan receivable balance and the information reported by the GAs on the Form 1130.

- We noted that the Office of Vocational and Adult Education (OVAE) does not have a systematic method for monitoring compliance with the Carl D. Perkins Vocational and Applied Technology Education Act (hereafter referred to as the Perkins Act). The Perkins Act is the legislation under which OVAE operates and delivers Basic Grants to states totaling approximately \$1 billion during fiscal year 1998.

In addition, based on discussion with OVAE management, it was noted that there will not be a systematic monitoring plan for fiscal year 1999. OVAE intends to focus on helping states implement the new legislation, which was enacted in October 1998. However, for fiscal year 1998, there was no monitoring in place for compliance with prior legislation. OVAE did participate in the Department-wide Program Coordinated Review Teams and site visit some states, however, these visits did not address compliance issues. OVAE plans to develop monitoring procedures and begin piloting them for the end of fiscal year 2000. By fiscal year 2001, all procedures should be in place.

- According to a recent report issued by the Office of Inspector General (OIG), (Audit Control Number 06-70004), students with defaulted student loans and with grant overpayments have received additional student financial aid (SFA). In addition, the OIG issued a report in June 1999 regarding "Improving the Process for Forgiving Student Loans" in which it identified control weaknesses in the current system for

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determining borrower eligibility for the disability or death discharge. The report indicated that student loans are being discharged for total and permanent disability and death, even though the borrowers are apparently not totally and permanently disabled or deceased. The OIG also found that new loans are being awarded to borrowers who returned to school after previously having loans discharged due to total and permanent disability.

Recommendations:

We recommend that the Department of Education perform the following:

1. Monitor the submission of reports to the Single Audit Clearinghouse in order to know when GLOS should expect to receive a report. GLOS also needs to monitor the year-ends of the GAs to determine when a report is due and check with the clearinghouse to determine if the report was submitted by the due date. This will facilitate GLOS' ability to initiate follow-up more timely.
2. Continue to work with the Clearinghouse to identify missing Single Audit reports and ensure that audit reports are received within the two months timeframe. IPOS completed a project this year to send letters to all IPOS institutions with overdue reports. The Department, and its divisions, should continue their efforts to more strictly enforce the submission requirements for Single Audits, such as impose authorized penalties if the audits are not received within the required timeframe.
3. More strictly enforce the requirements as stated in the Lender Audit Guide. However, we noted that GLOS imposes penalties on lenders who do not submit their report by the six month deadline. After a first notice, any lender who has not submitted a required report is issued a second notice stating that GLOS will begin withholding interest subsidy and special allowance payments. A small number of lenders (approximately twelve) were cut-off in fiscal year 1998, but all eventually submitted their reports. Since a relatively effective system is in place to enforce report submission, we recommend that GLOS consider imposing such penalties more quickly.
4. Strive to develop monitoring procedures that ensure compliance with provisions of the Perkins Act, and are capable of being conducted using the available resources of the Office of Vocational and Adult Education (OVAE). This could be accomplished by using an annual mail-in review process with a site visit every five years, or teleconferencing for staff interviews, so that there is personal communication between the reviewers and agency personnel. It seems that there may be several ways that monitoring can be accomplished using methods other than the traditional site visit.
5. Have a supervisor analyze and approve the field review report upon completion of an Impact Aid field review. According to Impact Aid management, a senior analyst should compare the field review to the input data used in generating the payment

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amount. However, we noted that this did not occur in this instance. We recommend that management ensure that this quality control procedure is completed on a consistent basis.

6. Appropriately address the recommendations in the OIG reports, “Applicants with Defaulted Student Loans Continue to Receive Student Financial Aid” (ED-OIG/A06-70004) and “Improving the Process of Forgiving Student Loans” (ED-OIG/A06-80001).

6. Insufficient Controls Surrounding Accounts Receivable/Cash Receipts

During our testing of accounts receivable and cash receipts, we noted several issues. The following are examples of the issues we encountered:

- We were unable to substantiate the Other Accounts Receivable account balance because the Department was unable to provide sufficient supporting documentation and a subsidiary ledger. For the limited documentation provided, the Department was unable to provide adequate explanations to support the accounts receivable balance. For example, we were unable to obtain sufficient explanations or support pertaining to the facilities loans receivable allowance.

The lack of supporting documentation presents an internal control weakness that management needs to address. Inadequate controls surrounding accounts receivable expose the Department to the risk of invalid transactions occurring without detection.

- During our cash receipts testing, we reviewed bank deposit tickets, deposit log sheets, and a query of FMSS. In comparing the dates on the supporting documentation, we noted that the checks were not being posted to FMSS in a timely manner. For example, checks that were received and deposited in May 1998, were not posted to FMSS until October 1998. Through inquiry of OCFO personnel, we noted that the time lag in posting the cash receipts was due to the office’s inability to process its workload in a timely manner as there was a lack of resources. We were informed that the OCFO was “backed-up” and that they were processing the oldest deposits first. Delays in posting cash receipts resulted in inaccuracies in the Department’s Cash account. According to data provided by the OCFO, the Cash account balance for fiscal year 1998 was understated by approximately \$4.3 million.

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Recommendations:

The Department of Education should perform the following:

1. Review its system requirements so that the Department can produce subsidiary ledgers in a timely manner, and substantiate all accounts receivable transactions.
 2. Enhance current policies and procedures to ensure that accounts receivable and related cash receipts are properly recorded. The policies and procedures should address, at a minimum, aging of the receivable, required supporting documentation, and a methodology for determining an allowance. In addition, procedures should require that cash receipts be recorded in the general ledger on a more timely basis, but at least monthly. Training should be provided to individuals responsible for performing functions surrounding accounts receivable.
- 7. The Department Needs to Establish Controls Over the Analysis and Reporting of Performance Measures (Repeat Condition)**

Congress enacted the Government Performance and Results Act (GPRA) of 1993 as a means to improve the management and accountability of Federal agencies. GPRA requires executive agencies to prepare multi-year strategic plans, annual performance plans, and annual performance reports. OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, sets forth the format and instructions for the form and content of agency financial statements. In an effort to consolidate reporting, including the reporting requirements of GPRA, OMB Bulletin No. 97-01 requires the performance measures in the overview section of the financial statements, as well as the other accompanying information, to be consistent with the measures used by agencies as part of their GPRA implementation efforts. Management's display of performance information should include sufficient explanatory information to help readers understand the significance of the measures, the results and any deviations from goals or plans.

Although the Department has developed a framework for the verification and validation of its performance indicators, it has not developed a process for assembling and analyzing data in accordance with OMB Bulletin No. 97-01 and GPRA for financial reporting purposes. We also noted that adequate guidance was not provided to the program offices within the Department in order to sufficiently prepare the overview to the Department's consolidated fiscal year 1998 financial statements.

Recommendations:

We recommend that the Department of Education establish a process for assembling the data and other information needed in the overview of the financial statements, which will ensure that the information is consistent with the Department's GPRA implementation

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efforts. The Department should ensure that this process is documented and communicated to all relevant personnel.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 1997 audit of the Department of Education's financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Figure 1: Summary of FY 1997 Material Weaknesses and Reportable Conditions

Issue Area	Summary Control Issues	FY 1998 Status
Loan Estimates for The Department's Loan Programs (Material Weakness)	The Department needs to establish the validity of its principal data store to provide a basis for preparing reliable loan estimates in the future and needs to establish sufficient controls to detect material errors in its loan estimates.	Resolved
FFEL Program-Guaranty Agency Oversight (Material Weakness)	The Department needs to complete steps underway for improving oversight of guaranty agencies	Partially Resolved - Repeat Condition (Reportable vs Material)
Fund Balances with Treasury (Material Weakness)	The Department's methods for reconciling differences between the budget clearing account (suspense) cash balance and Treasury need improvement	Repeat Condition
Financial Reporting (Material Weakness)	Improvements are needed to the financial reporting process so that the Department can meet the GMRA deadline.	Repeat Condition
Performance Measures (Reportable Condition)	The Department needs to establish controls over the analysis and reporting of performance measures.	Repeat Condition
Student Financial Assistance Programs (Reportable Condition)	Oversight and analysis of audits of postsecondary the Departmental institutions need improvement.	Partially Resolved - Repeat Condition
Controls Over Automated Systems (Reportable Condition)	Improvements are required in security over financial systems and in disaster recovery capabilities.	Repeat Condition

We have reviewed our findings and recommendations with Department management. They concur with our findings and recommendations and will provide an audit action plan to the OIG in accordance with applicable Department directives.

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In addition to the reportable conditions described above, we noted certain other matters involving internal controls and its operations that were reported to management in a separate letter dated September 15, 1999.

This report is intended for the use of the management of the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than the specified parties.

Ernst + Young LLP

September 15, 1999
Washington, D.C.

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources and financing for the year then ended, and have issued our report thereon dated September 15, 1999. The report states that because of the matters discussed therein, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the consolidated balance sheet as of September 30, 1998, and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

The management of the Department is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in Office of Management and Budget (OMB) Bulletin No. 98-08, *Audits of Federal Financial Statements*, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996.

The results of our tests of compliance disclosed the following instances of noncompliance with laws and regulations discussed in the preceding paragraph that are required to be reported under Government Auditing Standards or OMB Bulletin 98-08, as amended.

The Department did not comply with all of the requirements included in the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994. Specifically, the Department did not submit fiscal year 1998 audited financial statements to OMB by March 1, 1999, the statutory deadline.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin 98-08.

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The results of our tests disclosed instances where the Department's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph. The Report on Internal Control includes information related to the financial management systems and accounting standards that were found not to comply with the requirements, and presents relevant facts pertaining to the noncompliance and our recommendations related to the specific issues. Specifically, it was noted that the Department lacked adequate financial management systems, reports and oversight to prepare timely and accurate financial statements.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended for the use of the management of the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than the specified parties.

Ernst + Young LLP

September 15, 1999
Washington, D.C.