

**U.S. Department of Education**  
Office of Inspector General



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# Auditor's Guide

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For audits to ensure the accuracy of  
certain Federal Family Education Loan  
Program special allowance payments.

April 2007

# TABLE OF CONTENTS

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	<u>Page</u>
1. General Requirements .....	1
2. Audit Overview .....	6
3. Management's Assertions .....	13
4. Audit Procedures.....	19
5. Submitting Your Report.....	24
Attachment: Required Schedules.....	26
A. Management's Assertions	
B. Bond Worksheet	
C. Engagement Letter	
D. Audit Report	
E. Auditor's Certifications	
F. Lender's Response to Audit Report	

# CHAPTER 1

## GENERAL REQUIREMENTS

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### **What is the purpose of this Guide?**

This Guide provides requirements for an audit of a lender participating in the Federal Family Education Loan (FFEL) Program. The audit is an examination level attestation engagement on an assertion of the lender—referred to in this Guide as the “audit”—and is limited to verifying that, for the quarter ended December 31, 2006, a lender has accurately identified its first-generation and second-generation loans that are eligible for special allowance payments under the 9.5 percent floor. The Guide uses the Department’s methodology to identify eligible first-generation and second-generation loans.

This audit is required by the U.S. Department of Education’s (Department’s) Dear Colleague Letter FP-07-06 (April 2007) and by notification letters that the Department sent to lenders on January 24, 2007, in connection with Dear Colleague Letter FP-07-01 (January 23, 2007). The Dear Colleague Letters provide the terms under which the Department has agreed to accept loans as eligible for special allowance payments under the 9.5 percent floor.

### **Am I qualified to perform audits using this Guide?**

To perform the audit described in this Guide, you must meet the independence, professional judgment, and competence general standards specified in *Government Auditing Standards, January 2007 Revision* (GAS), including organizational independence, continuing education, and peer review requirements. A lender’s internal auditors do not meet GAS’s independence standards.

You must also comply with applicable provisions of the public accountancy law and with the rules of the jurisdiction in which you are licensed and where the engagement is being conducted. If the lender is located in a state outside your home state, you must document your

compliance with the licensing requirements of the public accountancy laws of that state.

### **How do I use this Guide?**

To perform an audit, both you and the lender must follow the requirements in Chapters 1 and 2 of this Guide. The lender must follow the procedures described in Chapter 3 to provide its Management's Assertions and, later, its reply to the auditor's report. You must follow the procedures described in Chapters 4 and 5 to verify Management's Assertions and report the results of the engagement.

This Guide includes Schedules that identify the required elements for Management's Assertions, your audit report, and other procedures for this audit. These schedules are included as an Attachment to this Guide and must be used by management and by you to provide this information.

### **How do I prepare for an audit?**

To ensure that you are using the most current guidance, you must first review our website for updated information regarding this Guide, at <http://www.ed.gov/about/offices/list/oig/nonfed/sfa.html>.

### **What general considerations are there for audits?**

Among other things, you should keep the following considerations in mind while you perform and report this audit:

- You must exercise due care in planning, performing, and reporting the audit, and you must exercise the proper degree of professional skepticism so there is a reasonable degree of assurance that material noncompliance will be detected.
- You must not ignore basic weaknesses in internal control, perform audit steps mechanically (auditing form over substance), or accept explanations for audit exceptions without acquiring adequate evidence.
- Since the Management's Assertions you are verifying will affect billing paid by the Department not only for the quarter ended December 31, 2006, but for future quarters, you must consider these additional amounts, if any, when assessing risk.

- You must design and perform procedures that can be reasonably expected to detect significant fraud or other illegal acts. To do this, you must be aware of fraud and high risk areas and must recognize any basic weaknesses in internal control.

### **What must I do if I detect fraud or other illegal acts?**

Some examples of high risk indicators specific to audits of lenders are provided below:

- Inadequate documentation.
- Social Security Numbers duplicated or erroneous.
- Billing under more than one lender ID (for example, having two accounts and billing for the same portfolio under both IDs).
- Undisbursed portions of multiple disbursed loans included in balances used for interest and special allowance computations.
- Reporting full balance of loan portfolio in two Categories.

If you detect fraud or any other illegal act, you must report it immediately to our Investigation Services, by phone or fax at the numbers shown below, before further extending audit steps and procedures:

Assistant Inspector General for Investigations  
U.S. Department of Education  
400 Maryland Avenue, SW  
Washington, DC 20202-1510

Phone: 202-245-6966

Fax: 202-245-6990

You must promptly prepare a separate written report, as instructed by our Investigations Services, and you must submit the report to the address provided above, either within 30 days after you discover the act or within a time frame agreed to by our Investigations Services and you.

You must exercise due professional care when pursuing any indication of fraud or any other illegal act, so that potential future investigations or legal proceedings are not compromised. See paragraphs 6.13 and 6.14 of GAS.

**What is your role in assuring the quality of my audit?**

We will evaluate your audits. As part of our evaluation, you must make supporting working papers available to us or our representative upon request. If we determine that you have submitted substandard working papers (for example, if you fail to document your work or conclusions in accordance with GAS), or that there are other major inadequacies in your audit, we may—

- Refer the issue to the cognizant State Board of Accountancy and the American Institute of Certified Public Accountants (AICPA), if you are a member;
- Take action to suspend or debar you from conducting additional U.S. federal program audits; or
- Act to recover civil penalties from you.

**What if my working papers contain confidential commercial information?**

“Confidential commercial information,” as defined by the Freedom of Information Act (FOIA), means trade secrets and commercial or financial information that is privileged or confidential, because disclosure could reasonably be expected to cause substantial competitive harm. If you or the lender believes that your working papers contain confidential commercial information, you should take appropriate steps to identify that information in your working papers, to protect its confidentiality.

If you are asked to submit your working papers to us, and we subsequently receive a request under FOIA for information that you have designated as confidential commercial information, we must make an independent determination of whether that information meets the criteria for exemption from release. To the extent permitted by law, we will make a good faith effort to notify you and provide you, or the lender, an opportunity to object if we disagree with your designation.

**Who can I contact about this Guide?**

If you are performing your audit under a contract with the Department, contact the official specified in that contract with any questions about this Guide or its requirements.

If you are performing your audit under a contract with the lender, and you have questions about this Guide or its requirements, contact—

U.S. Department of Education  
Office of Inspector General  
Assistant Director, Non-Federal Audits  
400 Maryland Ave., SW  
Washington, DC 20202-1510  
Phone: 202-245-6982  
Fax: 202-245-7088

# CHAPTER 2

## AUDIT OVERVIEW

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### **What is the objective of this audit?**

Identify loans included in the lender's special allowance billing for the quarter ended December 31, 2006, that qualify as first-generation or second-generation loans, eligible for special allowance payments under the 9.5 percent floor, according to the methodology established by the Department.

### **What kind of audit is this?**

This audit is an examination level attestation engagement on an assertion, as described in the AICPA's *Statements on Standards for Attestation Engagements* (SSAEs) and in GAS 1.23: "Consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects or the assertion is presented (or fairly stated), in all material respects, based on the criteria." Additional information about the audit type is included in Chapter 4 of this Guide.

### **What are first-generation and second-generation loans?**

First-generation and second-generation loans are the only loans billed by a lender that are eligible for special allowance payments under the 9.5 percent floor.

A lender participating in the FFEL Program is entitled to a quarterly special allowance payment for loans in its portfolio. In general, for Stafford loans, the amount of the quarterly special allowance payment is calculated in four steps:

1. Determining the average of the bond equivalent rates of either 91-day Treasury bills auctioned during the quarter, or for loans made in 2000 or later, 3-month commercial paper;
2. Adding a specified percentage to this amount (the specified percentage varies based on the loan type, origination date, and other factors);



3. Subtracting the applicable interest rate for the loan; and
4. Dividing the resulting percentage by 4. (34 C.F.R. § 682.302(c))

If a loan was made or purchased with the proceeds of a tax-exempt obligation that was originally issued before October 1, 1993, it may qualify for a separate, special allowance calculation that provides—with the interest paid on the loan—a minimum return of 9.5 percent. In this Guide, we refer to this separate calculation as the “9.5 percent floor.”

Under 34 C.F.R. § 682.302(c)(3)(i), to qualify for the 9.5 percent floor, a loan must be—

. . . made or purchased with funds obtained by the holder from—

(A) The proceeds of tax-exempt obligations originally issued prior to October 1, 1993;

(B) Collections or payments by a guarantor on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;

(C) Interest benefits or special allowance payments on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;

(D) The sale of a loan that was made or purchased with funds obtained by the holders from obligations described in paragraph (c)(3)(i)(A) of this section; or

(E) The investment of the proceeds of obligations described in paragraph (c)(3)(i)(A) of this section.

A summary of these eligible funding sources is provided below:

- **Source A:** Proceeds of the eligible tax-exempt obligation.
- **Source B:** Collections or payments on a loan funded by Source A.
- **Source C:** Interest benefits or special allowance payments on a loan funded by Source A.
- **Source D:** Funds obtained from the sale of a loan that was funded by Source A.
- **Source E:** The investment of funds in Source A.

Sources B through D consist exclusively of funds obtained directly from a loan funded by Source A. Applicable law treats loans made from Source E (earnings from the investment of bond proceeds) like loans made from Sources B through D.

An example is provided below:

- *Loan 1 (the “first-generation loan”)*, funded by the proceeds of the tax-exempt obligation, is eligible for the 9.5 percent floor because it is funded by Source A.
- *Loan 2 (the “second-generation loan”)*, purchased with funds obtained from the sale of Loan 1, is eligible for the 9.5 percent floor because it is funded by Source D.
- *Loan 3 (the “third-generation loan”)*, purchased with funds obtained from the sale of Loan 2, is not eligible for the 9.5 percent floor. It is not funded by Source D, because its funds were not obtained from the sale of a loan that was funded by Source A.

Dear Colleague Letter FP-07-01 (January 23, 2007) explains first-generation and second-generation loans as follows:

Loans acquired from these five sources can be divided into two categories. The first category is “first-generation loans” – and includes only those loans acquired using proceeds of the tax-exempt obligation (*i.e.*, funds obtained directly from the issuance of the tax-exempt obligation). . . . The second category is “second-generation loans” – and includes only those loans acquired using funds obtained directly from first-generation loans. . . . Funds obtained as collections on second-generation loans, interest and special allowance payments on second-generation loans, or sales of second-generation loans, or those same kinds of funds obtained from later generation loans, are not eligible sources of funds under the statute or regulation. Therefore, loans acquired with funds from second-generation loans or later generations of loans are not eligible for SAP at the 9.5 percent minimum return rate.

## Where can I find the criteria for this audit?

The criteria for this audit are provided in—

- Dear Colleague Letters FP-07-06 (April 2007), FP-07-01 (January 23, 2007), and FP-06-15 (October 6, 2006);
- Title 34 C.F.R. § 682.302, as amended in the Federal Register on August 9, 2006 (71 FR 45703 through 45705) and on November 1, 2006 (71 FR 64398); and
- Section 438(b)(2)(B) of the Higher Education Act of 1965, as amended (HEA) (20 U.S.C. 1087-1(b)(2)(B)), including amendments made by the Taxpayer-Teacher Protection Act of 2004 and by the Higher Education Reconciliation Act of 2005.

All of these sources are available on the Department's Information for Financial Aid Professionals web site, at <http://ifap.ed.gov>.

## What are some examples of criteria that I need to be aware of?

For example, a loan is ineligible if it—

- Is currently funded by a tax-exempt bond, issued on or after October 1, 1993, that did not refund, or was not one of a series of tax-exempt refundings of, a tax-exempt bond originally issued before that date.
- Is currently funded by a taxable bond that was used to refinance the loan after September 30, 2004.
- Is currently funded by a taxable bond but derived its eligibility from a tax-exempt bond that has matured or been retired or defeased from sources other than qualifying tax-exempt sources.
- Is pledged to a tax-exempt bond that matured or was refunded, retired or defeased after September 30, 2004.
- Unless the lender is a small lender, has an acquisition date later than February 7, 2006.

These requirements are in 34 C.F.R. § 682.302(c)(3)(i), (e), and (f). You need to be aware of these and other criteria as you conduct your audit, and you must report exceptions if they come to your attention.

## Why is this audit needed?

The attachment to Dear Colleague Letter FP-07-01 is a letter that was sent to all lenders currently claiming special allowance payments under the 9.5 percent floor. In this letter, the Department stated that it would make no further special allowance payments to lenders at the

9.5 percent floor rate until the lenders' first-generation and second-generation loans had been identified. This audit is needed to make that determination.

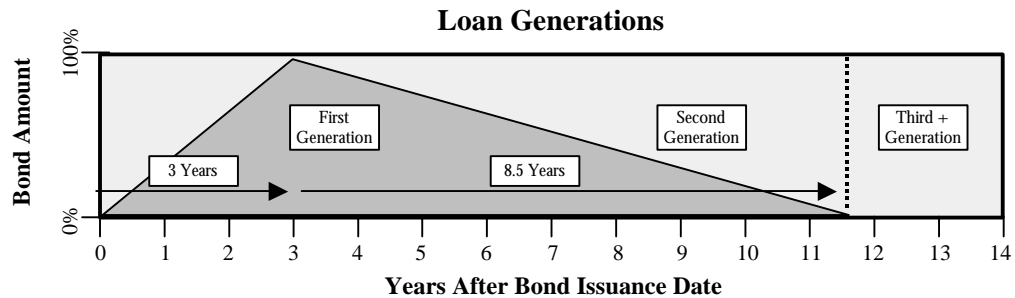
The attachment states—

The audit or review will be conducted by an independent accounting firm. As an alternative, you may arrange for the conduct of an audit or review by an independent accounting firm of your choosing, under a set of requirements to be established by the Department. The Department will pay all claims for SAP at the standard rate until the results of the audit or review have been received, evaluated, and accepted by the Department. We will consider, and rely upon, as appropriate the results of the audit or review in determining what amount to pay at the 9.5 percent minimum return rate.

**How can first-generation and second-generation loans be identified?**

The procedures that a lender must use to identify its first-generation and second-generation loans and make its Management's Assertions are described in Chapter 3. The procedures for the audit are described in Chapter 4.

The following chart provides a simplified illustration of the model used by the methodology in Chapter 3 to identify first-generation and second-generation loans:



In this simplified illustration, the first-generation loans are funded within the first three years of the bond's issuance, and are then paid down over the next 8.5 years. The funds that are used to pay down the first-generation loans are used to create second-generation loans. After the first 11.5 years of the bond's issuance, no first-generation loans remain as a source of funds, and any loans acquired thereafter are third-generation or later-generation loans.

In most cases though, additional factors will impact the audit methodology:

- A bond's first-generation loans may include consolidation loans, which would be paid down over a lifetime of 19 years, instead of the 8.5 year lifetime of non-consolidation loans;
- Loans will amortize beginning on various dates over the first three years after the bond's issuance date (the simplified illustration assumes that all loans begin to amortize on the same date, three years after the bond issuance date); and
- Lenders will use interest and special allowance payments on the first-generation loans to make second-generation loans.

The procedures described in Chapter 3 incorporate these additional factors into the model illustrated in the chart.

### What is a "small lender"?

As used in this Guide, a small lender is a lender that meets the criteria in 34 C.F.R. § 682.302(e)(5)(ii). It is a lender that—

(A) On February 8, 2006 and during the quarter for which special allowance is determined under this paragraph—

(1) Is a unit of State or local government or a private nonprofit entity, and

(2) Is not owned or controlled by, or under common ownership or control by, a for-profit entity; and

(B) In the most recent quarterly special allowance payment prior to September 30, 2005, held, directly or through any subsidiary, affiliate, or trustee, a total unpaid balance of principal of \$100,000,000 or less for which special allowance was determined and paid under paragraph (c)(3) of this section.

Under 34 C.F.R. § 682.302(e)(4), loans cannot become eligible for the 9.5 percent floor after February 7, 2006, or remain eligible if they are re-purchased after that date. However, small lenders are not subject to this provision until December 31, 2010. (34 C.F.R. § 682.302(e)(5))

If the lender that you are auditing asserts that it is a small lender, you will need to verify the lender's assertion and address this difference in your audit procedures.

**What process will be used for these audits?**

A lender must follow the procedures described in Chapter 3 to make its Management's Assertions and its reply to your report. You must follow the procedures in Chapter 4 to verify Management's Assertions and follow the procedures in Chapter 5 to report the results of your audit.

As stated in Dear Colleague Letter FP-07-06, the audit described in this Guide may be conducted either by an independent accounting firm under contract with the Department or, as an alternative, by an independent accounting firm of the lender's choosing. In both cases, the quality of the audits will be closely monitored by the Department.

# CHAPTER 3

## MANAGEMENT'S ASSERTIONS

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### **What are the steps a lender must follow for this audit?**

The lender follows the procedures in this Chapter to provide its Management's Assertions on Schedule A. If the lender is a small lender, it includes that assertion on the Schedule.

The lender documents the calculations that identify its first-generation and second-generation loans by completing a Bond Worksheet (Schedule B) for each eligible tax-exempt bond from which its loans derive eligibility for the 9.5 percent floor. After reviewing the auditor's report, the lender provides its response to that report on Schedule F.

### **How does a lender identify its first-generation and second-generation loans?**

The lender performs the following Steps to identify loans that are potentially eligible for the 9.5 percent floor and their funding bonds:

- 1) *Loan information.* List the loans billed under the 9.5 percent floor for the quarter ended December 31, 2006 (the "December 2006 loans"). Include in the list, for each loan—
  - a) the loan's—
    - identification number,
    - loan type,
    - billing code;
    - Lender's Request for Payment of Interest and Special Allowance (LaRS) special allowance category code ("X Code"); and
    - ending and average daily principal balances as of December 31, 2006.

- b) the identification number of the eligible tax-exempt bond from which the loan derives its current eligibility;<sup>1</sup>
  - c) the date on which the loan was originated or purchased by the eligible tax-exempt bond (the “acquisition date”);<sup>2</sup>
  - d) the amount of the bond’s funds used to originate or purchase the loan (the “acquisition amount”); and
  - e) the identification number of the bond issue currently funding the loan and the date on which the loan was originated or purchased by that bond.
- 2) *Bond information.* List the bonds from which the December 2006 loans derive their eligibility for the 9.5 percent floor.<sup>3</sup> Include in the list, for each bond—
- a) the bond’s identification number,
  - b) the total amount of the bond (the “bond amount”),<sup>4</sup> and
  - c) the date on which the bond was issued (the “bond issuance date”).<sup>5</sup>

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<sup>1</sup> A loan may derive its eligibility only from a tax-exempt bond originally issued before October 1, 1993, the proceeds of which were used to acquire either that loan or the loan that generated the funds used to acquire the loan in question.

<sup>2</sup> A loan’s acquisition date must be earlier than February 8, 2006. Under the Higher Education Reconciliation Act of 2005, except for small lenders, no loan originated or purchased on or after February 8, 2006, or not already earning 9.5 percent floor SAP on that date, can become eligible for SAP under the 9.5 percent floor.

<sup>3</sup> See Note 1.

<sup>4</sup> There may be cases in which an eligible tax-exempt bond, issued before October 1, 1993, refunded a prior, eligible tax-exempt bond and, at the same time, created additional money that was used to make loans eligible for the 9.5 percent floor. For example, tax-exempt Bond A is issued for \$75 million in 1985, and it funds loans eligible for the 9.5 percent floor. Tax-exempt Bond B is issued in 1992 for \$100 million: \$75 million is used to refund Bond A and \$25 million in new money is used to create additional loans eligible for the 9.5 percent floor. In this case—and in other, similar cases—this Guide’s use of the terms “bond amount” and “bond issuance date” refers to the portion of the bond from which a loan’s eligibility for the 9.5 percent floor is derived. In the example, of the \$100 million in loans funded by Bond B, \$75 million would remain associated with Bond A (the bond issuance date and bond amount would be the date and amount of Bond A, and that portion of Bond B would be treated like any other refunding bond) and \$25 million would be associated with Bond B (the bond issuance date and bond amount would be the date of Bond B and the amount of the new money added by Bond B, \$25 million). The lender would need to perform Steps 3 through 7 of this process separately for the \$75 million in loans for Bond A and the \$25 million in loans for Bond B’s new money.

<sup>5</sup> The bond issuance date for a refunding or refinancing bond is the same as the issuance date of the pre-October-1993, tax-exempt bond that was first refunded. As such, all issuance dates for bonds from which a loan derives its eligibility must be earlier than October 1, 1993.



The lender then uses a separate Bond Worksheet (Schedule B) to perform the following steps for each bond identified in Step 2:

- 3) *First-generation loans.* To identify a bond's first-generation loans—
  - a) List the December 2006 loans by acquisition date, from earliest to latest, and create running totals for the loan acquisition amounts.
  - b) If a loan's acquisition date is no more than 3 years after its bond's issuance date, and the running total including the amount for acquisition of that loan does not exceed the bond amount, the loan is a **first-generation loan**.
  
- 4) *Calculate second-generation cap.*
  - a) Total the acquisition amounts of the consolidation loans identified as first-generation loans in Step 3. This amount is considered to be the amount of the bond's first-generation loans that were consolidation loans.
  - b) Subtract the amount identified in Step 4a from the bond amount. The remainder is considered to be the amount of the bond's first-generation loans that were non-consolidation loans.
  - c) Calculate the total interest and special allowance payments that would accrue on the consolidation and non-consolidation loans identified in Steps 4a and 4b, over the life of the loans, using a straight-line amortization. Except for small lenders, do not include any interest or special allowance payments that would accrue after February 7, 2006. The calculation must assume that—
    - Combined interest and special allowance payments accrue at 9.5 percent per annum,
    - A bond's entire first generation of loans has been acquired within 3 years after the bond issuance date, in equal amounts in each of those 3 years, and
    - The lives of consolidation and non-consolidation loans are 19 years and 8.5 years, respectively.The calculation must also include an allowance for investment income on the unexpended balance of the bond proceeds, accruing at 9.5 percent per annum during the three-year period after the bond issuance date.
  - d) Using the same amortization schedule applied to the first-generation consolidation loans in Step 4c, identify the amount of principal outstanding for those first-generation consolidation loans on February 7, 2006.

- e) The **second generation cap** is determined by adding the bond amount to the amount determined in Step 4c and subtracting the amount determined in Step 4d.
- 5) *Second-generation loans (First Cut).*
- a) Omitting first-generation loans, list the December 2006 loans by acquisition date, from earliest to latest, and create running totals for the loan acquisition amounts.
- b) A loan is a **second-generation loan** if its acquisition date is no more than 11.5 years after its bond's issuance date and the running total including the amount for its acquisition does not exceed the second-generation cap calculated in Step 4.
- 6) *Second-generation loans (Second Cut).*
- a) Calculate the remaining amount of the second-generation cap by subtracting the running total expended through the acquisition of the last loan identified as a second-generation loan in Step 5b from the second-generation cap calculated in Step 4.
- b) Omitting first-generation loans identified in Step 3 and second-generation loans identified in Step 5, list the December 2006 loans by acquisition date, from earliest to latest, and create running totals for the loan acquisition amounts.
- c) A loan is a **second-generation loan** if its acquisition date is no more than 22 years after its bond's issuance date and the running total including the amount for its acquisition does not exceed the lesser of—
- The remaining amount of the second-generation cap (determined in Step 6a), or
  - The amount of principal, interest and special allowance payments (as calculated in Step 4c) that would accrue on the bond's first-generation consolidation loans (determined in Step 4a) during the period 11.5 to 22 years after the bond issuance date, excluding any amount that would accrue or would be required to be repaid after February 7, 2006 (or December 31, 2006, for a small lender).

- 7) *Billing amounts.*
  - a) Total the ending and average daily principal balances for the quarter ended December 31, 2006, for the first-generation loans identified in Step 3 and the second-generation loans identified in Steps 5 and 6.
  - b) Calculate grand totals for these amounts and provide them in item 1 of Schedule A.
  - c) Complete item 2 of Schedule A, review the remaining items, and sign in Section C of Schedule A.

**For Steps 3, 5, and 6, how does a lender identify a first-generation or second-generation loan if more than one loan have the same acquisition date?**

If more than one loan has the same acquisition date, and this ambiguity would affect the identification of loans as first-generation or second-generation loans, the lender orders the loans acquired on that date by the time of their acquisition, from earliest to latest. If that information is not readily available, the lender orders the loans acquired on the same date randomly.

**How does a lender perform the straight-line amortization required in Step 4?**

Lenders are required to use the Microsoft Excel spreadsheets we have developed for this purpose (the “Bond Spreadsheets”). Instructions on the Bond Worksheet (Schedule B) identify the data that must be entered into the Bond Spreadsheet by the lender. These instructions also identify the data that must be entered into the Bond Worksheet by the lender, from the calculations of the Bond Spreadsheet.

The Bond Spreadsheets—one for small lenders and another for all other lenders—are available at the following web site:

<http://www.ed.gov/about/offices/list/oig/nonfed/sfa.html>

To use a Bond Spreadsheet, follow the instructions on its first worksheet, tabbed, “Schedule B Calculations.”

**What if a lender disagrees with the results of the audit?**

The lender documents its disagreement with the audit results on the Lender's Response to Audit Report, Schedule F. The lender is required to complete Schedule F for all audits, to document its agreement or disagreement with the audit results.

The lender may dispute the results of application of this methodology only on the ground that the auditor erred in applying the methodology stated in this Guide. The lender must explain each instance in which it contends that the auditor erred, and demonstrate that application of the methodology correctly would identify as first-generation or second-generation loans one or more loans not identified as such in the audit.

The Department will consider each dispute on a case-by-case basis, as part of its review of the audit report.

**What if a lender disagrees with the method this Guide uses to identify first-generation and second-generation loans?**

This Guide may not be used to audit an assertion by a lender that is not the result of the procedures described in this Guide. A lender that disputes the Department's methodology stated in this Guide may not use this Guide, its procedures, or its underlying assumptions to establish the eligibility of its claims for special allowance payments at the 9.5 percent floor rate.

# CHAPTER 4

## AUDIT PROCEDURES

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### **What are the steps I follow to perform this audit?**

The lender gives you its Management's Assertions (Schedule A), which includes its Bond Worksheets (Schedule B). You then follow the procedures in this Chapter to test management's assertions. If you are being paid by the lender to perform the audit, you must complete Schedule C, Engagement Letter, before beginning the audit.

You report the results of your audit using Schedule D and provide your certifications on Schedule E. You follow the procedures in Chapter 5 of this Guide to obtain the lender's response to the audit report on Schedule F and assemble and submit the audit package to the Department.

### **What type of engagement is this?**

This audit is an examination level attestation engagement, as defined in GAS 1.23. You must follow applicable GAS and SSAE requirements for this type of engagement when performing the audit. All references to GAS in this Guide refer to its January 2007 version (GAO-07-162G).

GAS 6.05 specifies additional attestation engagement fieldwork standards that go beyond the requirements contained in the SSAEs. In performing this engagement, auditors must comply with these additional standards. These standards relate to—

- 1) Auditor communication during planning;
- 2) Previous audits and attestation engagements;
- 3) Internal control;
- 4) Fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that could have a material effect on the subject matter;

- 5) Developing elements of a finding; and
- 6) Documentation.

**How do I define *materiality*?**

You use the applicable requirements in GAS to develop your definition. During the audit you must consider the effect of the lender's compliance with the procedures in this Guide on special allowance payments made to the lender by the Department, not only for the quarter ended December 31, 2006, but for future quarters. You must consider these additional amounts, if any, when developing your definition of materiality, and your considerations on materiality should be properly documented in the audit working papers.

**What if the lender has more than one Lender ID?**

Some lenders bill the Department for special allowance payments under multiple Lender IDs or may use the Lender IDs of one or more eligible lender trustees to bill the Department for their loans. Some lenders may submit separate reports for each lender ID, and others may combine their lender IDs into one or more reports. The lender you are auditing is required to disclose all of its Lender IDs to you on its Management's Assertions.

**Must I review the lender's previous audit reports as part of my audit?**

Yes. You ask the lender's management to identify all reports of previous audits and reviews of the lender issued within the two years immediately preceding your audit. This includes reports for the previous compliance audit and for any OIG audits, FSA program reviews, FFEL Program guarantee agency reports, licensing agency reports, and other audits or program reviews related to the lender's compliance with FFEL Program requirements issued during that two-year period.

You must identify all unresolved prior findings that are material to this audit, the status of their resolution, and the actions necessary for the lender to resolve those findings. To do this, you may find it necessary to test the status of the prior findings. For example, you may need to observe an activity that was redesigned to address a prior finding, or you may need to test transactions, similar to those in the prior finding, that are material to an examination of the Management's Assertions.

**If the lender uses a servicer, how do I test the lender's assertions?**

You must first obtain the servicer's most recent audit report from the lender. If the audit report contains findings of noncompliance that are material to this audit, you assess the effect of the noncompliance on the nature, timing, or extent of substantive tests at the lender. If significant noncompliance is disclosed in the servicer's audit, you assess the effect of that noncompliance on this audit of the lender and include that information in the audit report.

A servicer may maintain records or provide services for the lender that must be examined in order to perform the audit steps described in this Chapter. If this is the case, you must examine the servicer's records or services as if they were the lender's. Depending on the nature of the records or services, this may require a separate on-site visit at the Servicer to perform the audit steps.

**What audit steps must I perform?**

You must perform the following audit steps:

- 1) *Obtain information from lender.* You must obtain from the lender—
  - a) the lender's Management's Assertions and Bond Worksheets (Schedules A and B) and any attachments; and
  - b) if you are being paid by the lender, you and the lender must complete an Engagement Letter (Schedule C).
  
- 2) *Verify status as small lender.* If in item 2 of its Management's Assertions, the lender asserts that it is a small lender, you must review—
  - a) the charter, documents of incorporation, audited financial statements, or any other documents needed to determine whether the lender is a unit of State or local government, or is a private nonprofit entity that is not owned, controlled, or under common ownership or control by a for-profit entity; and
  - b) the lender's billing records to confirm that, in its most recent quarterly special allowance payment before September 30, 2005, the lender held, directly or through any subsidiary, affiliate, or trustee, a total unpaid balance of principal of \$100,000,000 or less for which the Department paid special allowance under the 9.5 percent floor.

- 3) *Ensure that data are reliable.* Follow the guidance in the Government Accountability Office's *Assessing the Reliability of Computer-Processed Data* (GAO-03-273G, October 2002) to ensure that data used in the audit are reliable. At a minimum, you must—
  - a) select and test a sample of loans in the electronic data attached to the Management's Assertion to verify that it is accurate: the loan's tax-exempt bond issue, acquisition date, acquisition amount, loan type, and other information must accurately reflect the information in the Lender's data system;
  - b) evaluate and analyze the query used by the lender to select the data attached to the Management's Assertions, to ensure that the query did not include or exclude loans inappropriately; and
  - c) test the universe of loans queried by selecting a sample of loans in the lender's data system and verifying that those loans are accurately represented in the data attached to the Management's Assertions.
- 4) *Verify amounts and issuance dates of bonds used to qualify loans for the 9.5 percent floor.* Use the bond's prospectus, IRS Form 8038, and other documents to verify the amount of the bond. Determine that the bond identified as the bond from which the loan derives its eligibility—
  - a) is a tax-exempt bond;
  - b) was originally issued before October 1, 1993 (if the bond with which the loan is currently associated is a refunding bond, the tax-exempt bond it refunded meets this requirement, either directly or through an intervening refunding bond); and
  - c) after September 30, 2004, did not mature and was not retired or defeased.
- 5) *Conduct preliminary test of loans.* Verify that all loans in the list have a "BC" billing code, indicating that the amount is for special allowance for the current quarter.
- 6) *Identify first-generation and second-generation loans.* Using the data you verified in Steps 1 through 5 identify the lender's first-generation and second-generation loans using the procedures provided to lenders in Chapter 3. Compare the result to the lender's Management's Assertions and Bond Worksheets.
- 7) *Verify lender's billing under the 9.5 percent floor.* Verify that, for the quarter ended December 31, 2006—



- a) the total average daily principal balance for the lender's eligible first-generation and second-generation loans is the same as the amount reported by the lender in item 1a of its Management's Assertions; and
- b) the total ending principal balance for the lender's eligible first-generation and second-generation loans is the same as the amount reported by the lender in item 1b of its Management's Assertions.

**How do I select my sample for Step 3?**

All samples must be selected randomly. If the total number of loans in the universe is 500 or greater, select a minimum sample of 50 loans. If the total number of loans in the universe is less than 500 loans, select a minimum random sample of 10 percent of the loans or 10 loans, whichever is greater.

If you determine that material noncompliance may exist, you must expand the sample in order to evaluate the error statistically. Your expanded sample must be sufficient to project the error rate to the universe at the 95 percent confidence level, with a confidence interval of  $\pm 5$  percent.

# CHAPTER 5

## SUBMITTING YOUR REPORT

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### **How do I report the results of my audit?**

You complete and submit Schedule D, Audit Report, following the instructions provided on the Schedule. You also read and sign the Auditor's Certifications, on Schedule E, and obtain the lender's response to the audit report, on Schedule F.

### **What must be included in the audit report package?**

Your audit report package must include—

- All the Schedules and Bond Worksheets that are required by this Guide for the audit;
- Any separate report on illegal acts that you submitted under the procedures described in Chapter 1;
- Any additional reports or communication between you and the lender concerning the audit; and
- A cover letter, on your company's letterhead, signed by a responsible official.

The cover letter may include any additional statements or information not required on the Schedules but required under your company's practices. The minimum elements of your audit report (Schedule D) and the auditor certifications (Schedule E) must be included in the audit report package on those schedules, but may be duplicated in your cover letter, if you wish.

**When and to whom do I submit my audit report package?**

If you are performing your audit under a contract with the Department, your report is due and delivered under the terms of the contract.

If you are performing your audit under a contract with the Lender, you must submit the audit report to the Department no later than September 30, 2007.

The audit report package must be addressed to—

U. S. Department of Education  
Federal Student Aid, Financial Partners Services  
Union Center Plaza  
830 First Street NE, Room 84F3  
Washington, DC 20202-5353  
Attn: SAP Audit Reports

# ATTACHMENT

## REQUIRED SCHEDULES

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This Attachment includes the following Schedules:

- Schedule A: Management's Assertions
- Schedule B: Bond Worksheet
- Schedule C: Engagement Letter
- Schedule D: Audit Report
- Schedule E: Auditor's Certifications
- Schedule F: Lender's Response to Audit Report

# SCHEDULE A

## MANAGEMENT'S ASSERTIONS

### SECTION A: PROVIDE IDENTIFYING INFORMATION ABOUT THE LENDER.

Lender's name:

Lender's ID Number(s) used to bill any special allowance payments under the 9.5 percent floor:

### SECTION B: PROVIDE BILLING AMOUNTS.

1. The management of our lender asserts that, under the procedures and criteria in the *Auditor's Guide*, for the eligible first-generation and second-generation loans in its special allowance billing for the quarter ended December 31, 2006—
  - a. The total average daily principal balance is \$ \_\_\_\_\_.
  - b. The total ending principal balance is \$ \_\_\_\_\_.

### SECTION C: ASSERT SMALL LENDER STATUS.

2. Is your lender a small lender, as that term is defined in the *Auditor's Guide*?  Yes  No

### SECTION D: PROVIDE ADDITIONAL ASSERTIONS.

In addition, the management of our lender asserts that—

3. It has attached to this Schedule, in an electronic format, the list required under lender procedures Step 1 in Chapter 3 of the *Auditor's Guide*. The list is complete and accurate, and it identifies eligible first-generation and second-generation loans according to the procedures and criteria in the *Auditor's Guide*.
4. It has attached to this Schedule the completed Bond Worksheets, on Schedule B, for each of its eligible bonds.
5. It has made available to the auditor all documentation and communications related to its compliance with the requirements and procedures in the *Auditor's Guide*.
6. It has not provided interpretations to the auditor for any requirements in the *Auditor's Guide* that may have varying interpretations.
7. It has internal controls in place to monitor and ensure the accuracy of the amounts it provides on this Schedule, and these amounts include only loans that are first-generation and second-generation loans obtained from an eligible source, as described in the Department's Dear Colleague Letter (FP-07-01), dated January 23, 2007, and no others.
8. It has disclosed to the auditor and to the audit committee all significant deficiencies in the design and operation of the internal controls that could adversely affect the accuracy of the information provided on this schedule, as well as any fraud, whether or not material, that involves management or any other employee connected to the information provided on this Schedule A.

### SECTION E: LENDER'S PRESIDENT OR CEO SIGNS.

The management of the lender identified in Section A confirms that the assertions provided on this Schedule A, and in its attachments, are true and accurate to the best of its knowledge and belief.

\_\_\_\_\_  
Signature of President or CEO

\_\_\_\_\_  
Title (Print)

\_\_\_\_\_  
Date Signed

# SCHEDULE B

## BOND WORKSHEET

### STEP 2: BOND INFORMATION.

- A** \_\_\_\_\_ Bond Identification Number (*Enter into Bond Spreadsheet, Line 1*)
- B** \$ \_\_\_\_\_ Bond Amount (*Enter into Bond Spreadsheet, Line 2*)
- C** \_\_\_\_\_ Bond Issuance Date: Can't be later than October 1, 1993 (*Enter into Bond Spreadsheet, Lines 3 through 5*)

### STEP 3: FIRST-GENERATION LOANS.

- D** \_\_\_\_\_ End date: **C** + 3 years (*From Bond Spreadsheet, Line 11*)
- E** \$ \_\_\_\_\_ Total acquisition amount of first-generation loans: can't be greater than **B**

### STEP 4: CALCULATE SECOND-GENERATION CAP.

- F** \$ \_\_\_\_\_ Total acquisition amount of consolidation loans in first generation (*Enter into Bond Spreadsheet, Line 7*)
- G** \$ \_\_\_\_\_ Total acquisition amount of non-consolidation loans in first-generation: **B** - **F** (*From Bond Spreadsheet, Line 8*)
- H** \$ \_\_\_\_\_ Total interest and SAP over life of first-generation loans (*From Bond Spreadsheet, Line 13*)
- I** \$ \_\_\_\_\_ Amount of principal outstanding for first-generation consolidation loans on February 7, 2006 (*From Bond Spreadsheet, Line 14*)
- J** \$ \_\_\_\_\_ Second Generation Cap: **B** + **H** - **I** (*From Bond Spreadsheet, Line 15*)

### STEP 5: SECOND-GENERATION LOANS (FIRST CUT).

- K** \_\_\_\_\_ End date: **C** + 11.5 years (*From Bond Spreadsheet, Line 17*)
- L** \$ \_\_\_\_\_ Total acquisition amount of first-cut second-generation loans: can't be greater than **J**

### STEP 6: SECOND-GENERATION LOANS (SECOND CUT).

- M** \$ \_\_\_\_\_ Remaining amount of second-generation cap: **J** - **L**
- N** \$ \_\_\_\_\_ Amount of principal, interest, and special allowance payments that would be due or accrue on the first-generation consolidation loans (*From Bond Spreadsheet, Line 16*)
- O** \_\_\_\_\_ End date: **C** + 22 years (*From Bond Spreadsheet, Line 18*)
- P** \$ \_\_\_\_\_ Total acquisition amount of second-cut second-generation loans: cannot be greater than **M** and cannot be greater than **N**

### STEP 7: BILLING AMOUNTS.

- Q** \$ \_\_\_\_\_ Total ending principal balance for quarter ended December 31, 2006
- R** \$ \_\_\_\_\_ Total average daily principal balance for quarter ended December 31, 2006

# SCHEDULE C ENGAGEMENT LETTER

**SECTION A: PROVIDE INFORMATION ABOUT THE LENDER.**

1. Lender's name and address (street, city, state, zip), including any aka's:

2. President's name:		3. Contact person's name and title:	
4. Contact person's telephone:	5. Contact person's fax:	6. Contact person's e-mail address:	

**SECTION B: PROVIDE INFORMATION ABOUT THE AUDITOR.**

7. Auditing firm's name and address (street, city, state, zip):

8. Lead auditor's name:		
9. Lead auditor's telephone:	10. Lead auditor's fax:	11. Lead auditor's e-mail address:
12. Lead auditor's license (Home State):		13. Lead auditor's license (Out of State):

**SECTION C: CERTIFICATIONS.**

14. Our signatures below certify that—

- a. The lender identified in Section A has engaged the auditor identified in Section B to perform the audit described in the *Auditor's Guide*.
- b. The audit must be performed and reported in accordance with the *Auditor's Guide*, as issued by the U.S. Department of Education's Office of Inspector General.
- c. The U.S. Department of Education intends to use the auditor's report to ensure the accuracy of the lender's special allowance payments for Federal Family Education Loan Program loans.
- d. The auditor is required to provide access, on request, to records, audit work papers, and other documents necessary to review the audit (including the right to obtain photocopies) to the U.S. Department of Education, to the Inspector General, and to their representatives (34 C.F.R. §§ 668.23(e)(1)(ii) and 682.305(b)(5) and (c)).

**SECTION D: LENDER AND AUDITOR SIGN.**

15. Signature for Lender:

a. Signature	b. Title (Print)	c. Date Signed
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16. Signature for Auditor:

a. Signature	b. Title (Print)	c. Date Signed
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# SCHEDULE D AUDIT REPORT

**SECTION A: PROVIDE IDENTIFYING INFORMATION ABOUT THE LENDER.**

Lender's name:	Lender's ID Number(s):	Date of Lender's Assertion (Schedule A):
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**SECTION B: PROVIDE THE RESULTS OF YOUR AUDIT (If needed, provide continuations of responses on separate sheets)**

1. In your opinion, are management's assertions on Schedule A fairly stated, in all material respects, based on the criteria set forth in the *Auditor's Guide*, issued by the U.S. Department of Education, Office of Inspector General, dated April 2007 (the "*Auditor's Guide*")?  Yes  No

2. If you answered "No" to item 1, explain below:

3. a. Were the loans you identified as first-generation and second-generation loans (in Step 6 of the audit procedures in the *Auditor's Guide*) the same loans identified as first-generation and second-generation in the list provided by the lender for Schedule A?  Yes  No

b. If you answered "No" to item 3a, explain below. You must identify all exceptions between your lists of first-generation and second-generation loans and the lender's lists of eligible first-generation and second-generation loans. If it is more convenient, you may attach to this schedule, in an electronic format, your complete list identifying first-generation and second-generation loans.

4. If you answered "No" to item 3a, provide your totals for the lender's special allowance billing for the quarter ended December 31, 2006:

- a. Total average daily principal balance for all eligible first-generation and second-generation loans: \$ \_\_\_\_\_.
- b. Total ending principal balance for all eligible first-generation and second-generation loans: \$ \_\_\_\_\_.

5. a. In the table below, provide information about your samples for each bond. Identify the total dollar amounts in the universe, in your sample, for sample error, and for projected error, for each bond tested:

Bond ID	Entire Population Amount	Sample Population Amount	Sample Error	Projected Error
	\$	\$	\$	\$
	\$	\$	\$	\$
	\$	\$	\$	\$
	\$	\$	\$	\$

b. If the sample was expanded to evaluate the projected error rate statistically, provide information about the sample's confidence level and precision below:

6. a. During your audit, did you identify any material instances of non-compliance with the Higher Education Act of 1965, as amended, regulations, or other guidance provided by the U.S. Department of Education?  Yes  No

b. If you answered "Yes" to item 6a, explain below:

7. a. Was there any restriction on the scope of the audit?  Yes  No

b. If you answered "Yes," explain below:



# SCHEDULE E

## AUDITOR'S CERTIFICATIONS

### SECTION A: PROVIDE IDENTIFYING INFORMATION ABOUT THE COMPLIANCE AUDIT.

Lender's name:	Lender's ID Number(s):	Date of Lender's Assertion (Schedule A)
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### SECTION B: AUDITOR'S CERTIFICATION.

The signature below certifies that—

1. We have examined management's assertions, accompanying this report as Schedule A, concerning the amounts of the lender's loans that are eligible for the 9.5 percent floor special allowance payments, as described in the *Auditor's Guide*, issued by the U.S. Department of Education, Office of Inspector General, dated April 2007 (the "*Auditor's Guide*").
2. The lender identified in Section A is responsible for management's assertions. Our responsibility is to express an opinion on the assertions based on our examination.
3. Our examination was conducted in accordance with generally accepted government auditing standards for attestation engagements and with attestation standards established by the American Institute of Certified Public Accountants.
4. Our examination included procedures, specified in the *Auditor's Guide*, to test evidence supporting management's assertions and performing such other procedures that we considered necessary in the circumstances.
5. Our opinion on management's assertions is provided on Schedule D and is based on the criteria set forth in the *Auditor's Guide*. We believe that our examination provides a reasonable basis for our opinion.
6. This engagement was performed using procedures prescribed in the *Auditor's Guide*. The sufficiency of these procedures is solely the responsibility of the report's users. We can make no representations regarding the sufficiency of the procedures.
7. If we had performed additional procedures, other matters might have come to our attention that would have been reported. As a result, this report is intended solely for the information and use of the audit committee, management, and the U.S. Department of Education. It is not intended to be, and should not be, used by anyone other than these specified parties.

### SECTION C: AUDITOR SIGNS.

I certify that the statements on this Schedule and on Schedule D, including any attachments, are true and accurate to the best of my knowledge and belief.

\_\_\_\_\_  
Signature for Auditor

\_\_\_\_\_  
Title (Print)

\_\_\_\_\_  
Date Signed

# SCHEDULE F

## LENDER'S RESPONSE TO AUDIT REPORT

**SECTION A: PROVIDE IDENTIFYING INFORMATION ABOUT THE LENDER.**

Lender's name:

Lender's ID Number(s):

**SECTION B: PROVIDE YOUR RESPONSE TO THE AUDIT REPORT.**

1. Do you concur with the Audit Report?  Yes  No
- 
2. If you answered "No" to item 1, for your special allowance billing for the quarter ended December 31, 2006, provide the total amounts you assert are eligible first-generation and second-generation loans—
- a. The total average daily principal balance is \$\_\_\_\_\_.
- b. The total ending principal balance is \$\_\_\_\_\_.
- 
- 3 If you answered "No" to item 1, explain below (if needed, provide additional information on separate sheets). Your explanation must use your Bond Worksheets (attached to Schedule A) to demonstrate your understanding of the correct application of the methodology.

**SECTION C: LENDER'S PRESIDENT OR CEO SIGNS.**

The management of the lender identified in Section A confirms that the information on this Schedule, and on any attachments, is true and accurate to the best of its knowledge and belief.

\_\_\_\_\_  
Signature of President or CEO

\_\_\_\_\_  
Title (Print)

\_\_\_\_\_  
Date Signed

\_\_\_\_\_  
Name (Print)

\_\_\_\_\_  
Telephone Number