Appendix F: Audit Reports

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

JAN 3 1 2003

Honorable Roderick Paige
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

The enclosed reports present the results of the audits of the Department's annual financial statements for the fiscal years ended September 30, 2002 and 2001, to comply with the Government Management Reform Act of 1994 (GMRA). The reports should be read in conjunction with the Department's financial statements and notes to fully understand the context of the information contained therein.

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

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

Ernst & Young, LLP, identified other matters involving internal control and its operations that were not considered reportable conditions under professional auditing standards, 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 audits.

Sincerely,

Thomas A. Carter
Deputy Inspector General

Enclosures

ERNST & YOUNG

■ Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

■ Phone: (202) 327-6000
www.ey.com

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the fiscal years then ended and the consolidated statement of changes in net position, the combined statement of budgetary resources and the consolidated statement of financing for the fiscal year ended September 30, 2002. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have previously identified certain aspects of the Department's financial reporting process as material weaknesses in internal control during fiscal year 2001. The account analysis and reconciliation processes used by the Department in 2001 were not fully effective in compensating for these material weaknesses. During fiscal year 2001, the Department revised the opening balances in its previously issued financial statements. We were unable to obtain sufficient evidence or to otherwise satisfy ourselves as to the accuracy or completeness of those adjustments. In addition, the Department was unable to provide adequate documentation to support certain amounts reported in its consolidated balance sheet. These amounts included approximately $827 million in total assets and $396 million in total liabilities and net position for fiscal year 2001, that required further analysis and investigation to determine if such amounts had been recorded properly. As described in Note 19, the results of further analysis performed during fiscal year 2002 resulted in additional adjustments to the 2001 financial statements.

In our opinion, except for the effects of such adjustments to the consolidated balance sheet as of September 30, 2001 and the related consolidated statement of net cost for the year then ended, if any, as might have been determined to be necessary had we been able to examine sufficient evidence regarding the adjustments and amounts referred to in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2002 and 2001, and its net cost for the years then ended, and changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the fiscal year ended September 30, 2002, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management Discussion and Analysis of the Department and the Supplemental Information is not a required part of the basic financial statements, but is supplementary information required by Office of Management and Budget Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our reports dated January 17, 2003, on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

Ernst + Young LLP

January 17, 2003
Washington, D.C.

ERNST & YOUNG

Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

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

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the fiscal years then ended and the consolidated statement of changes in net position, the combined statement of budgetary resources, and the consolidated statement of financing for the fiscal year ended September 30, 2002, and have issued our report thereon dated January 17, 2003. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheet and the related consolidated statement of net cost as of and for the year ended September 30, 2001.

Except for the matters discussed in the third paragraph of the Report of Independent Auditors, we conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal control, determined whether this internal control had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal control relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

In addition, with respect to internal control related to performance measures reported in the Management Discussion and Analysis of the Department's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. 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.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 01-02, 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 Department's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions 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 misstatements 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. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected. However, we noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be reportable conditions. The remainder of this report details the reportable conditions, the first of which is considered a material weakness.

MATERIAL WEAKNESS

1. Financial Management, Reconciliations and Account Analysis Need to be Strengthened (Modified Repeat Condition)

Overview

OMB Circular A-127 requires 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 control, and reliable data. During significant periods of time in fiscal year 2002, the Department was not able to successfully complete reconciliations and other types of account analysis on a timely basis.

The Department continues to work towards resolving these issues, which, in the FY 2001 and prior financial statement audits reports, related to the lack of an integrated financial management system and inadequate financial reporting processes. During FY 2002, the Department implemented a new general ledger software package to replace the old Financial Management System Software (FMSS). The new system is also known as FMSS. In addition, Federal Student Aid (FSA), a performance based organization within the Department, also implemented a financial management system (FMS) during FY 2002 to support their management information reporting needs. Batched data files are periodically transferred from FMS to FMSS. Management also asserted that they executed certain actions to control the system implementation process and improve the systems capability and accounting records, including:

- Conducted independent verification and validation (IV&V) and post production validation (PPV) studies of the new financial management system to evaluate whether transactions were being posted correctly, and made corrections as needed based on the results of these studies.

- Preparing quarterly financial statements beginning in March 2002, which helped the Department to identify certain areas needing further study.

- Required Department employees to attend training on internal control to enhance the Department's ability to improve internal controls.

While progress has been made, significant financial management issues continued to impair the Department's ability to accumulate, analyze, and present reliable financial information during FY 2002. Our review of the internal control at the Department disclosed weaknesses in the Department's ability to report accurate financial information on a timely basis. These weaknesses are primarily due to deficiencies in certain of the Department's financial management practices, including inadequate reconciliations and account analysis early in FY 2002. Issues associated with the transition to a new financial management system in FY 2002 also contributed to the Department's difficulties in these areas. We did note improvements in the latter part of the fiscal year. Over the last several years, the Department has recorded several billion dollars in adjustments to its accounts. These adjustments were processed to correct unnatural account balances or otherwise adjust balances to the amounts management's analysis supported. In many cases, the cause of the incorrect balances could not be definitively determined, and the entry prepared by management was a reasoned judgment of how to correct its accounts. This solution persisted in 2002, as discussed below, regarding an unlocated difference between amounts recorded in the Department's records for defaulted FFEL loans and amounts in guaranty agency records.

We noted that the Department did not identify financial management or reconciliation processes as a material weakness in its Federal Managers' Financial Integrity Act (FMFIA) report for fiscal year 2002. We continue to believe that the Department needs to place additional focus on reconciliation procedures, account analysis, and financial reporting.

We did note that the Department implemented several processes during fiscal year 2002 to improve its financial management processes including:

- The convening of the Accounting Integrity Board, the Audit Steering Committee, and the Accounting Assurance group to plan, implement and manage quality accounting change control
- The establishment of the Financial Statement Committee, continuation of the Financial Statement Preparation Team and other special task force teams all of which are designed to improve the financial statement processes.
- The development and implementation of reconciliation work plan, policies and procedures, specialized teams and regular management reviews of the final work products as well as management review for process improvement.

Reconciliation Procedures Need to be Improved

A major objective of internal control is to ensure the integrity of the underlying accounting data supporting the financial statements. An important control in this regard is the 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 allows management the ability to analyze its financial condition and results of operations on a routine basis.

Strong internal control over the reconciliation process helps ensure the timely detection and correction of errors in underlying accounting records. The Department's performance of reconciliations in fiscal year 2002 was inconsistent, with the implementation of new financial management systems contributing to difficulties with these processes in some instances. As discussed later in this report, system integration issues between FMSS and the Department and FSA's feeder systems resulted in certain types of transactions not being posted to either FMS or FMSS for a majority of the fiscal year. This adversely impacted the Department's ability to perform timely reconciliations and account analysis, and to prepare accurate interim financial statements.

The following provides examples in which reconciliations were not performed properly or on a timely basis:

FFEL and Direct Loan Reconciliations

As discussed in the FY 2001 Report on Internal Control, we noted differences between the amounts of FFEL loans receivable reported in the general ledger and amounts reported by guaranty agencies. Based on questions raised during the course of the FY 2001 and FY 2002 financial statement audits, the Department began to research this issue. This process was not completed until significantly after September 30, 2002 and resulted in the restatement of the FY 2001 FFEL loans receivable balance and allowance for subsidy by approximately $1.3 billion.

In addition, the Department's supervisory review and approval procedures over reconciliations do not appear to be adequate in all cases. Certain reconciliations between the Department's feeder systems and the general ledger are performed by loan servicing contractors and are then approved by Department personnel. Although the reconciliations we reviewed had evidence of supervisory review and approval, in some instances, it appeared that the approval of the reviewers was largely an administrative activity, in that they were unable to answer questions about the reconciliations.

We noted that reconciliations were not always performed timely. The Department's policy is that reconciliations should be finalized within 45 days after month-end. Certain reconciliations, including DCS to FMS to FMSS, and FMS to DLSS were not performed until substantially after these timeframes. We also noted instances in which certain other reconciliations were not performed timely during the year, such as Fund Balance with Treasury, and GAPS to FMSS grant expense. Some of this is attributable to the implementation of new financial management systems.

Fund Balance with Treasury Reconciliations

The Department has had difficulty identifying and resolving differences between its accounting records and cash transactions reported by the U.S. Department of the Treasury for several years.

For portions of FY 2002, the Department was not reconciling its Fund Balance with Treasury (FBWT) accounts in a manner that allowed for the timely clearance of reconciling items. At June 30, 2002, the Department had over 40,300 unreconciled (unmatched) Treasury payment schedules. At June 30, 2002 over 16,000 unmatched Treasury payment schedules were over six months old. The Department's records indicated that many of these unmatched schedules had cleared by year-end, with approximately 7,300 unmatched schedules remaining at September 30, 2002. The net amounts within the unmatched schedule amounts at year-end appear to indicate that differences are generally within the same appropriation. Most of the unmatched schedules are related to the FFEL liquidating and financing funds, the direct loan financing fund, and the budget clearing account, with nearly half of the unmatched absolute value amount in the FFEL financing fund (X4251). Management indicated that as of October 2002, approximately 6,900 of these schedules remained unmatched.

The Department adjusted its FBWT accounts to reflect the amounts reported by Treasury, assuming that the differences were largely within the same appropriation accounts and would eventually clear. While this approach appears to be a reasoned one given the circumstances, at year-end, it can defeat the primary purpose of reconciliation processes to ensure that differences are timely and accurately researched and resolved.

Although we noted improvements in this area during the year, certain unreconciled differences continue to remain unresolved in fiscal year 2002. Consistent with the prior year, the Budget Clearing account (F3875), which reflects a debit balance of approximately $14 million as of September 30, 2002, and the suspense account (91F3885), which reflects a credit balance of $69 million as of September 30, 2002, have not been fully reconciled as of the date of this report. The Department indicates that the activity in these accounts relates to reclassifications of amounts between appropriations and timing differences. Management had not yet determined the final resolution of these amounts.

In addition, the Department did not submit certain periodic financial reports on budget execution for the FFELP liquidating and financing accounts to Treasury as required during the year due to reconciliation problems with Fund Balance with Treasury. We noted that the reports for the period ended September 30, 2002 were submitted.

Direct Loan File Processing Difficulties

For much of FY 2002, the Department experienced problems posting certain direct loan servicing transactions (IF010 files) to the FSA system, FMS, and FMSS. Batch files of detailed direct loan servicing transactions are periodically transferred from the Direct Loan Servicing System (DLS) to the FSA FMS system, and then from FMS to FMSS. Until June 2002, this data was not fully captured by FMS or FMSS because the direct loan IF010 files were not passing system edits and therefore could not be posted to the general ledger. While this issue was resolved in July 2002, it adversely impacted the Department's ability to reconcile its accounting records and prepare accurate financial statements for a large portion of the fiscal year.

Implementation of FMS

As previously discussed, the Department and FSA implemented new financial management systems during FY 2002, with FMSS considered the official books of record and FMS functioning in a manner similar to a subsidiary ledger. These system implementations posed a variety of challenges for the Department, particularly the FMS implementation. Certain components of FMS have not yet been fully implemented, such as the accounts receivable module. During FY 2002, FMS did not function as a complete subsidiary ledger, but was used to process loan-related transactions. FSA reconciles its feeder systems to FMS, and then compares direct loans receivable and accrued interest receivable from its feeder systems through FMS to FMSS. OCFO posts additional transactions to these accounts within FMSS, such as subsidy payments and lender disbursements. It is unclear whether OCFO or FSA is fully responsible for monitoring all the activity of the direct loan and FFEL general ledger accounts, reconciling account activity, and providing quality assurance and validation checks. Management has indicated that they plan to establish separate sub-accounts for FSA activity within the general ledger, which may assist in resolving this issue.

Additional Compensating Controls, Including Account Analysis, Need to be Strengthened

The U.S. General Accounting Office's *Standards for Internal Control in the Federal Government* states that internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the agency's control objectives. Examples of control activities include: top level reviews of actual performance, reviews by management at the functional or activity level, segregation of duties, proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions and internal control. These controls help ensure that errors and irregularities are detected in a timely manner. Department management has taken additional steps to strengthen internal controls, but further efforts are needed as discussed below.

Account Analysis

The Department's procedures for account analysis and reconciliations are evolving. We noted improvements in fiscal year 2002, such as the analysis of certain general ledger account balances performed by the Department and the development of procedures to reconcile FSA's trading partner data to FMS and FMSS. However, we noted the need for additional improvement. As a result of our audit and management's subsequent review of general ledger balances, various manual adjustments were made to reclassify and adjust the account balances reported in the financial statements and related notes to the financial statements. For example, we noted significant increases in intragovernmental accounts receivable and accounts payable balances in the financial statements. These variances occurred because the Department did not perform appropriate eliminating entries to account for the effects of intra-Departmental transactions. As a result, these balances were overstated on the draft financial statements. While not affecting the consolidated financial statements, we also noted that the Department did not perform certain allocations between the FFEL and direct loan program that impact the other liabilities line items of the balance sheet. Although the Department has made improvements in the financial statement preparation during FY 2002, we noted that the initial version of the year-end financial statements provided for audit contained mathematical errors in various notes to the financial statements, and certain amounts did not agree between the financial statements to their related notes. Had the Department performed more effective periodic analysis of its general ledger accounts and financial statements, these errors could have been identified and corrected by management. While the Department has made significant progress in this area, further strengthening procedures to analyze general ledger accounts and financial statement line items is warranted.

Review for Improper Payments

We have been informed by the Department and the Office of Inspector General (OIG) of several instances of improper payments, including duplicate payments. Management indicated that there were a small number of known instances of duplicate payments made during fiscal year 2002. The amount of the duplicate payments was not material, and, in many cases, funds have been accounted for and appropriately reflected in the financial statements. The Department has also identified an immaterial amount of duplicate or erroneous payments that have occurred in FY 2003.

It is our understanding that the Department is working to resolve issues identified in General Accounting Office (GAO) and OIG projects to identify improper payments and to review controls surrounding the disbursement process. That work identified a number of potential improper payments, missing computer equipment, improper Pell Grant awards, and inappropriate travel and purchase disbursements. We understand that the Department has begun to implement data mining techniques to identify potential abnormal Pell Grant disbursement patterns, and has implemented revised procedures for reconciling and approving purchase card transactions, trained purchase card approving officials in the revised procedures, and blocked certain purchase Merchant Category Codes to improve internal controls over purchase cards. Investigations of grantee, lender guaranty agencies and educational institutions, and improper payments also inform the Department's process to refine its internal control. We believe efforts to learn from these projects and refine controls are critical in reinforcing the Secretary's initiative to become a world-class financial management organization.

Additional Improvement Needed in Financial Reporting to Meet Accelerated Deadlines

Beginning in FY 2003, the Department will be required to submit quarterly interim financial statements within 45 days after the end of the quarter as part of the requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements.* In addition, year-end audited financial statements will be due November 15 beginning in FY 2004. While the Department has made improvements in certain aspects of financial reporting, critical challenges remain to be resolved in order for the Department to be able to prepare timely and accurate financial statements under these significantly accelerated deadlines.

Recommendations:

We recommend that the Department of Education perform the following:

1. Perform timely reconciliations of all significant accounts and programs, both proprietary and budgetary, on at least a monthly basis. Reconciliations should also be performed between subsidiary ledgers or feeder systems and FMSS 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 timely manner. In addition, a supervisory review of the reconciliations should be performed. Pertinent reconciliations performed by FSA and other Department offices should be coordinated with the Financial Management Office within OCFO.

2. Develop additional procedures surrounding the resolution of unmatched schedules within Fund Balance with Treasury. While we understand that some level of suspense items are unavoidable, the Department should specify in absolute dollars, number of transactions, and net amount terms, levels of unmatched schedules that would warrant delays in month-end closing and require immediate resolution, and resolve unreconciled differences specific to the Budget Clearing and suspense accounts on a timely basis.

3. Enhance account analysis procedures and define approaches to corroborate account balances for all significant accounts on a monthly or more frequent basis as appropriate, and document difference amounts that should be brought to the attention of senior management.

4. Further implement data mining and other approaches to search for duplicate payments and research improper payments that are identified and continue to refine internal controls in response to such efforts.

5. Develop an approach to financial reporting that will enable the Department to meet the accelerated due dates for interim and year-end financial reports required by OMB.

Such an approach may include assessing the need to accelerate procedures for the monthly general ledger close, financial statement preparation, reconciliations, account analysis and other significant financial management activities. The timeliness of receipt of critical information from guaranty agencies, lenders, grantees and other program participants should also be addressed. In addition, the Department's approach should ensure that the additional information included in the Performance and Accountability Report will be available in time to meet the new deadlines.

REPORTABLE CONDITIONS

2. Improvement of Financial Reporting Related to Credit Reform Is Needed (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure an agency's cost of federal loan programs. As part of implementing the requirements of the Credit Reform Act, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. As a result of our testing, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates could be improved. OMB Circular A-123 defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

We noted that the Department made progress on this reportable condition during FY 2002, including improving the process used to develop required financial statement disclosures, monitoring the information that flows through the allowance for subsidy for direct loans and liability for loan guarantees accounts, beginning a process to study key assumptions in the subsidy models, and participating in a Department/OMB Student Loan Audit Modeling Working Group.

During our testing of loan guarantees, allowance for subsidy, and subsidy costs estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the FFEL loan program is reflected in the financial statements through periodic charges for subsidy and recognition of liabilities for loan guarantees. The Department uses a computer-based cash flow projection model and OMB calculator to calculate subsidy estimates related to the program that are then recorded in the liability account. The model uses multiple sources of loan data and hundreds of assumptions. Also reflected in the liability account is the FFEL loan activity for such items as interest supplement payments, claim payments, and fee collections. The high volume of activity, multiple sources of data, and sensitivity of assumptions used to record subsidy cost, subject the liability account to a significant level of inherent risk of misstatement. We noted several issues that the Department must continue to take into consideration regarding the sufficiency of the assumptions used in the model. The Department utilizes the standard actuarial technique of "back casting" the subsidy estimates against actual results to research relationships in the data. Such analysis indicates that: (1) the model has underestimated interest benefits compared to actual amounts for the last 5 years, and (2) in more recent years collections have also exceeded estimates due in part to significant consolidation activity. Similar analysis for the direct loan program, although not as well developed, indicates that interest earnings from the spread between the rates students pay and the borrowing rate from the Treasury are off sharply in 2002 due to the decline in short term interest rates. In the absence of a regression of these results over the coming years compared with the model estimates, an assumption implicit in the implementation of the credit subsidy models, reestimates could be necessary to adjust the subsidy calculations for the actual experience to date.

- In addition to significant judgments which must be made in assessing actual versus forecast results from the models, other assumptions must be critically assessed, including: (1) the expected cash flows from consolidation activity and the loans themselves, (2) the appropriateness of projecting direct loan activity by reference to FFEL activity, and (3) impacts from other program changes, such as the effects of fixed rate consolidations and income contingent repayment provisions. During the past three years, the dollar volume of FFEL and direct loans that have been consolidated into new loans has accelerated significantly. The Department does not have significant history of repayment data or historical trend analysis for defaults, repayments, and other cash flows for loans that have been classified as consolidated. In addition, the Department is not easily able to identify all cash flows related to consolidations in order to sufficiently develop the payment history of these loans. While not readily quantified by the Department, the cash flows from consolidations can have a significant role in the re-estimate process. Further, as previously stated, the number and dollar amount of consolidated loans has increased significantly in the last few years. For example, in 2002, direct loan consolidations of approximately $9 billion accounted for over 45% of new direct loans. This amount includes approximately $1.8 billion of defaulted FFEL loans that were consolidated into direct loans. FFEL consolidations were in excess of $17 billion during FY 2002. Additionally, the sources of consolidated loans include poorer performing loans. In fiscal year 2002, approximately 80% of new consolidation loans of previously defaulted loans selected the income contingent repayment option. Early identification of trends, particularly in moving borrowers between the FFEL and Direct Loan programs and information regarding default risks and the types of loans being consolidated, is important to the estimation process.

- In addition, some of the same assumptions that are used for the FFEL program as are used for the direct loan program. The Department has historically utilized this approach since sufficient historical data was not available for direct loans. Given that nine years of data is now available for the direct loan program, the Department should evaluate whether the assumptions used for direct loans need to be updated. The Department's analysis of direct loan default experience for cohort years 1996-1999 indicates that actual default rates are higher than the estimated rates used, which are based on FFEL assumptions. Finally, direct loan borrowers are increasingly taking advantage of income contingent repayment plans. The growth of these types of loans exposes the Department to increased variability in the timing and ultimate amount of cash flows, all of which directly impact the credit reform calculations.

- Formalized written procedures are needed to improve communication between OCFO, FSA and Budget Service in monitoring loan estimation accounts, performing routine quality assurance and validation checks of account activity, preparing supporting documents for adjustments, or providing explanation for changes from one year to next in the loan liability and allowance for subsidy estimates. During FY 2002, we noted some improvement in the sharing of loan estimation information among the three organizations. For example, the three organizations worked closely together in reconciling the guaranty agency activity to the general ledger and the liability for loan guarantees estimate. Without formal written policies and procedures, the Department increases its risk that financial reporting and loan model estimates are not properly executed to achieve management and program objectives.

Recommendations:

We recommend that the Department of Education perform the following:

1. Catalog the most significant aspects of the assumptions used in projecting credit program subsidies, expose such assumptions to critical assessment by Department management and other interested parties in a transparent manner, and develop decision rules regarding when such assumptions are to be changed based on actual results, program revisions, or the availability of additional data.

2. Gather data in a manner that will enable the Department to better monitor and report on consolidations, and accelerate studies to validate the basis of assumptions used to determine the effect of loan consolidations, income contingent loan repayment terms, and fixed rate consolidation offers to ensure that subsidy models are updated timely for the best available information.

3. The long-term cost of direct loans is estimated based in part on FFEL cash flow activity. The Department should determine whether the effect of using actual direct loan cash activity for future projections of direct loan subsidy cost would result in a better estimate.

4. Continue to refine the direct loan backcast and forecast comparison to actual results process, and develop analytic tools to validate the appropriateness of the subsidy allowance for direct loans.

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

In connection with the annual audit of the Department's fiscal year 2002 financial statements, we conducted a controls review of the information technology (IT) processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

During fiscal year 2002, the Department has made progress in strengthening controls over information technology processes. The development of guidance from the Office of the Chief Information Officer related to controls and the reinforcement of existing controls should help the Department to increase the effectiveness of internal controls in areas such as security management. However, we find that continuous effort is needed to further address control weaknesses related to information technology and systems. In particular, audit reports by the General Accounting Office (GAO) and the Office of Inspector General (OIG), including the September 2002 Department of Education's Implementation of GISRA Year 2, audit control number ED-OIG/A11-C0008, prepared by the OIG, identify control weaknesses that need to be addressed.

With respect to overall security management, the Department needs to continue efforts to develop, implement, and maintain an agency-wide risk based information security plan, programs, and practices to provide security throughout the life cycle of all systems. Specifically, the Department needs to strengthen controls over updating its network infrastructure to secure mission-critical systems against common security vulnerabilities and exposures, implement comprehensive incident response procedures, establish clear lines of responsibility for information system security, and strengthen controls over critical financial and sensitive information to prevent unauthorized access and disclosure. The Department also identified its IT Security Program as a material weakness in its FY 2002 Federal Managers' Financial Integrity Act report.

The conditions previously discussed regarding financial management, reconciliations, and account analysis indicate that internal control within the Department is evolving and requires additional improvement. In some cases, the lack of compensating manual controls increases the need for strong information technology controls to ensure the integrity and security of the Department's data.

Recommendation:

The Department should implement corrective actions outlined in the September 2002, audit report "Department of Education's Implementation of GISRA Year 2", audit control number ED-OIG/A11-C0008, prepared by the OIG. Specifically, the Department should implement actions to address the following issues:

- Implement a comprehensive agency-wide security program,
- Strengthen controls over updating its network infrastructure to secure mission-critical systems against common security vulnerabilities and exposures,
- Implement comprehensive incident response procedures, and
- Establish clear lines of responsibility for information system security.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2001 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 2001 Material Weaknesses and Reportable Conditions

Issue Area	Summary Control Issues	FY 2002 Status
Financial Management Systems and Financial Reporting Need to Be Strengthened (Material Weakness)	Significant financial management issues continue to impair the Department's ability to accumulate, analyze, and present reliable financial information. These weaknesses are primarily due to the absence of certain components of a fully integrated financial management system.	Improvements Noted – Remaining conditions included in Material Weakness comment on Reconciliations
Improvement of Financial Reporting Related to Credit Reform is Needed (Reportable Condition)	Management controls need to be strengthened over financial reporting related to credit reform.	Improvements Noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements Noted – Modified Repeat Condition Reportable Condition
Reporting and Monitoring of Property and Equipment Needs to be Improved (Reportable Condition)	There are several internal control issues surrounding the Department's efforts in safeguarding and reporting property and equipment.	Not Considered a Reportable Condition – Issues Reported in the Management Letter

We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated January 17, 2003.

This report is intended solely for the information and 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 these specified parties.

Ernst + Young LLP

January 17, 2003
Washington, D.C.

ERNST & YOUNG

Ernst & Young LLP
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

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

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the fiscal years then ended and the consolidated statement of changes in net position, the combined statement of budgetary resources and the consolidated statement of financing for the fiscal year ended September 30, 2002, and have issued our report thereon dated January 17, 2003. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheet, and the related consolidated statement of net cost as of and for the year ended September 30, 2001.

Except for the matters discussed in the third paragraph of the Report of Independent Auditors, we conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

The management of the Department is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. We have identified the following instances of noncompliance:

- Significant financial management issues continued to impair the Department's ability to accumulate, analyze, and present reliable financial information during FY 2002. Issues associated with the transition to a new financial management system in FY 2002 contributed to the Department's difficulties in providing reliable, timely information for managing current operations and timely reporting of financial information to central agencies. For example, during much of FY 2002, the Department experienced problems posting certain direct loan servicing transactions to the financial management system because the files were not passing system edits and could not be posted to the general ledger. Certain other financial management controls, such as reconciliation processes, are continuing to evolve. While the Department appropriately submitted reports on budget execution for the period ended September 30, 2002, we noted that the Department did not submit certain periodic financial reports on budget execution for the Federal Family Education Loan Program (FFELP) liquidating and financing accounts to Treasury as required during the year due to reconciliation problems with Fund Balance with Treasury.

- The Department has made progress in strengthening controls over information technology processes during FY 2002. However, audit reports prepared by the General Accounting Office (GAO) and the Office of Inspector General (OIG) identify certain control weaknesses that need to be addressed. With respect to overall security management, the Department needs to continue efforts to develop, implement, and maintain an agency-wide risk based information security plan, programs, and practices to provide security throughout the life cycle of all systems. Specifically, the Department needs to strengthen controls over updating its network infrastructure to secure mission-critical systems against common security vulnerabilities and exposures, implement comprehensive incident response procedures, establish clear lines of responsibility for information system security, and strengthen controls over critical financial and sensitive grant information to prevent unauthorized access and disclosure. The Department also identified its IT Security Program as a material weakness in its FY 2002 Federal Managers' Financial Integrity Act report, citing the need to strengthen information technology systems to comply with the Computer Security Act and OMB Circular A-130, *Management of Federal Information Resources*.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and to the extent findings and recommendations were noted in prior years has provided a proposed action plan to the Office of Inspector General in accordance with applicable Department directives.

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 solely for the information and 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 these specified parties.

Ernst + Young LLP

January 17, 2003
Washington, D.C.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

THE CHIEF FINANCIAL OFFICER

JAN 28 2003

MEMORANDUM

To: Thomas A. Carter
Deputy Inspector General

From: Jack Martin

Subject: Draft Audit Reports
Fiscal Year 2002 Consolidated Financial Statement Audit
U.S. Department of Education
ED-OIG/A17C0008

The Department has reviewed the draft Fiscal Year 2002 Report of the Independent Auditors, Report on Internal Control, and the Report on Compliance with Laws and Regulations. We agree with the Report of the Independent Auditors, and have no material disagreements with the Report on Internal Control and the Report on Compliance with Laws and Regulations.

Our new accounting system, which was implemented January 22, 2002, corrected many of the deficiencies primarily due to not having a fully integrated financial management system. Moreover, we continue to actively strengthen our systems security.

We will share the audit results with responsible senior officials, other interested program managers, and staff. At that time we will also request that they prepare corrective action plans to be used in the resolution process.

Please convey my appreciation to everyone on your staff who worked diligently on our financial statement audit. Please contact me at 401-3892 with questions or comments.